S Corporation Reasonable Compensation

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Reasonable Compensation

- S corporations must pay reasonable compensation to a shareholder-employee in return for services that the employee provides before non-wage distributions may be made.
- The amount of reasonable compensation will never exceed the amount received by the shareholder either directly or indirectly.

Reasonable Compensation

- Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation.
- Several court cases support the authority of the IRS to reclassify other forms of payments to a shareholder-employee as a wage expense which are subject to employment taxes.
Court Cases

<table>
<thead>
<tr>
<th>Authority to Reclassify</th>
<th>July v. Commissioner, 211 F.3d 1269 (8th Cir., 2000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reasonable Reimbursement for Services Performed</td>
<td>David E. Watson, P.C. v. U.S., 666 F.3d 1008 (8th Cir. 2012)</td>
</tr>
</tbody>
</table>

What IRS Looks For?

- For the S corporation shareholder/employee, the Service is typically concerned with an unreasonably low level of employee compensation
- For a C corporation, the Service is typically concerned with an unreasonably high (or excessive) level of employee compensation
  - Menards case

What Does the IRC Say?

- There four requirements for an employee compensation income tax deduction per Reg. §1.162-7:
  - 1. The expense must be ordinary and necessary
  - 2. The amount must be reasonable
  - 3. The amount must be based on services actually rendered, and
  - 4. The expenses must be actually paid or incurred by the taxpayer corporation
Establishing Compensation
Where Do We Start?

- The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation
- What is the source of the S corporation's gross receipts
- The three major sources are:
  - Services of shareholder,
  - Services of non-shareholder employees, or
  - Capital and equipment
- If the gross receipts and profits come from items of service and are associated with the shareholder’s personal services, then profit distribution should be allocated as compensation

Where Do We Start?

- In addition to the shareholder-employee direct generation of gross receipts, the shareholder-employee should also be compensated for administrative work performed for the other income producing employees or assets
- For example, the shareholder-employee may not directly produce gross receipts, but instead assists the other employees or assets which are producing the day-to-day gross receipts
- Some factors in determining reasonable compensation:
  - Training and experience
  - Duties and responsibilities
  - Time and effort devoted to the business
  - Dividend history
  - Payments to non-shareholder employees
  - Timing and manner of paying bonuses to key people
  - What comparable businesses pay for similar services
  - Compensation agreements
  - The use of a formula to determine compensation

S Corporation Factors

- The S corporation shareholder/employee compensation should be reasonable in amount and for services rendered
- Reg. § 31.3121(d)-1(b), the S corporation officers are considered to be employees of the corporation when they provide more than minor (substantial) services to the corporation
- Rev. Rul. 59-221, provides that S corporation shareholder income distributions are exempt from self-employment tax
S Corporation Factors

- Rev. Rul. 74-44, allows the dividends paid to an S corporation shareholders can be recharacterized as wages when it appears the dividends were paid in lieu of reasonable compensation for services performed.
- The Tax Courts and other federal courts look at several factors when determining if a payment is either a dividend or employee compensation.

What Constitutes Reasonable Compensation?

- What constitutes reasonable compensation and how it’s treated for federal tax purposes are issues that arise for a wide range of organizations, including closely held C corporations, family businesses and S corporations.
- An IRS publication provides insight into how taxpayers can expect the agency to review compensation reported on tax returns — and possibly avoid an audit or tax court appearance.
  - The guidance comes in the form of a “job aid”.
  - It’s intended to assist the IRS analysts in their examination of reasonable compensation.
  - IRS analysts must determine whether compensation paid is reasonable and, therefore, deductible under § 162 of the Internal Revenue Code.
  - § 162 defines reasonable compensation as the amount that would ordinarily be paid for like services by like organizations in like circumstances.
  - It considers both the reasonableness of the total amount paid and the services rendered.

Reasonable Compensation Job Aid for IRS Valuation Professionals

- The job aid is not an official position and was prepared for references purposes only and may not be cited as authority for setting a legal position.
- It does provide some insights into how IRS approaches the issue:
  - Case coordination
  - The issue of reasonable compensation
  - Taxpayer arguments
  - Consideration of penalties
  - Information on Non-Profits
- The guide was developed by the Large Business and International Division.
3 Approaches

• The market approach - the most commonly used method – favored by the courts
• The income approach; and
• The cost approach - the least used method

Who is Effected?

• Reasonable compensation issues on tax returns typically arise in several contexts:
  – Closely held C corporations
  – Foreign Corporations
  – Family Businesses
  – S corporations
  • To avoid payroll taxes, an S corporation could underpay owners for their contributions to the business and, instead, pay out hefty distributions
  • Distributions paid to owners generally aren’t taxable to the extent that the owner has positive basis in the company

Other Issues that Could be Effected

• Loan – no interest, low interest or loans disguised as compensation
• Any adjustment proposed for prior year compensation amounts
• Acquisitions and divestitures/sales
Market Approach

- Under this approach, the determination of the reasonableness of an employee’s compensation is made by comparing the employee’s compensation with the compensation of employees performing similar duties at similar companies.
- Ideally, the companies for comparison would be mirror images of the company being analyzed.
- Due to challenges in matching employees at comparable companies with those of the subject company and in obtaining relevant compensation information for those comparable employees, the other approaches have been developed to determine Reasonable Compensation.

Resources

- General Industry Surveys by Standard Industry Code (SIC) and North America Industry Classification System (NAICS).
- Salary surveys within the industry look at trade organizations, trade journals, or analysts studies.
- Proxy Statements/Annual Report for publicly traded companies—These are filings required by the Securities Exchange Commission (SEC).
  - It may be difficult to identify similar companies.
  - If a larger company pays less compensation to a comparable employee, this may be an indication that the taxpayer’s compensation is not reasonable.
- Proxy Statements/Annual Reports can be ordered directly from companies or retrieved from Standard & Poor’s Research Insight and Compustat, Capital IQ, Lexis/Nexis, or the SEC website.
- Private company compensation information—Sometimes private companies disclose compensation records to obtain loans, financing, grants, etc. - Dun & Bradstreet or Risk Management Association.

Income Approach

- This method determines whether an independent investor would be satisfied with the business’s financial performance at the current owners’ compensation levels.
Income Approach

- The income approach can only be correctly applied when the Fair Market Value (FMV) of the company is available for each year that compensation is being examined.
- The FMV of a business entity often changes from year to year and can be a time consuming challenge to determine for any single year.
- As a result, the market approach is generally more useful than the income approach in a reasonable compensation analysis.
- The income approach is based on an “Independent Investor Test,” which seeks to determine whether an independent investor would be satisfied with his/her return on investment when looking at the financial performance of the taxpayer’s business in conjunction with the subject employee’s level of compensation.
  - Review: Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1325 n.33 (5th Cir. 1987) where the Court agreed with the Service’s position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue.

Cost Approach

- A valuator breaks the employee’s duties into its components, uses salary surveys to determine market compensation for each component and calculates a total cost.
- The guidance notes that standard appraisal practice requires consideration of all three approaches, but the IRS guidance generally favors the market approach.
- The income and cost approaches, as well as financial analysis, serve to refine the reasonable compensation estimate.

Cost Approach

- The Cost Approach breaks the duties of the employee into its components such as:
  - Company administration
  - Accounting
  - Finance
  - Marketing
  - Advertising
  - Engineering
  - Purchasing, etc.
Cost Approach

- The IRS agent will interview or issue an IDR requesting the total hours worked by the employee related to assigned job functions
- Salary surveys are then used to determine the “cost” of each job duty performed by the employee
- These are added up to arrive at a total “cost” to replace the duties/services of the employee
- This approach breaks the hours spent by the employee down into the various:
  - Duties performed
  - Quantifies the amount of time devoted to the different responsibilities, and
  - Compares the employee’s salary to market compensation for comparable positions

Cost Approach Weakness

- A weakness of the cost approach is that an employee might perform many tasks to some degree
- It is often difficult to accurately allocate the employee’s time to each position and it is also difficult to find market salaries for comparable part-time positions
- It is inappropriate to add up market salaries of multiple positions on a full-time basis as this would distort the amount of total time actually worked

Other Issues to Consider

- To assess the likelihood of reasonable compensation issues, IRS analysts are instructed to consider several factors, including:
  - 1) the entity’s process for setting compensation
  - 2) the number of employees at issue
  - 3) tax return information (including compensation items that don’t appear on an individual’s Form W-2)
  - 4) salary surveys
- They’re also advised to make sales comparisons (between officers’ compensation and company sales) and taxable income comparisons
- Typically such comparisons are made by adding the subject compensation back into taxable income to see if the adjustment significantly changes taxable income
Audit Scrutiny

- When auditing compensation deductions, an IRS analyst usually will scrutinize the following:
  - Employee qualifications, background, experience and knowledge of the business
  - Nature, extent and scope of the employee’s duties (including the character and degree of responsibility the employee assumes)
  - Time the employee devotes to the business
  - Size and complexity of the business
  - General and local economic conditions
  - Whether compensation is predetermined based on activities to be performed or not determined until the end of the tax year
  - How much the employee was paid in prior years,
  - Salary policy for all employees, and
  - Amounts paid by similar-size businesses in the same sector to equally qualified employees for performing similar services

IRS Interview

- It is important to conduct a thorough interview with the employee whose compensation is under examination
- A good interview reveals the employee’s experience, duties, knowledge, and responsibilities at the company
- Failure to interview the employee may result in the taxpayer subsequently presenting facts that the Valuation Analyst did not get a chance to consider
- If necessary, a Summons may be used to compel the employee to appear for an interview
- An additional option is to swear in the employee and prepare an Affidavit containing the employee’s statement under oath

Bottom Line

- Although standard appraisal practice requires the consideration of all three approaches, the reconciliation in the case of Reasonable Compensation will generally rest heavily on the market approach (comparison to compensation for similar positions in similar companies)
- The income and cost approaches, as well as financial analysis, are then used to refine the reasonable compensation amount
### IRS Will Perform a Detailed Analysis

- **Experience**
- **Duties**
- **Knowledge**
- **Responsibilities**

### Step to Identify Reasonable Compensation Issues

- **Process for setting compensation**
  - Consider how compensation is determined in the organization
  - Is there a Compensation Committee or some other specific body charged with determining appropriate compensation levels and is it independent from the individual(s) whose compensation is being set
  - Is there a requirement for a higher level approval from an independent committee or body, for example, a company’s officers or board of directors
  - Does the company keep contemporaneous records documenting the process for compensation determinations
  - Are salary surveys or comparables used to help in the determination of appropriate compensation based on an employee’s job requirements, education, background, skill levels or other relevant factors
  - Are the employees for whom compensation is being set in a position to significantly influence the result of the process either directly or through related parties or persons with which they have other business relationships

### Tax Return Information

- It is important to look at an employee’s total compensation package
- Some of the compensation may not be listed on the Form W-2
## Forms of Compensation

- Automobile Allowance
- Awards/Prizes Over $25 in Value (Gift Cards or Certificates in Any Amt.)
- Back Pay Awards
- Bonuses - Cash or Noncash
- Cafeteria Plan
- Commissions
- Company Owned or Leased Airplane
- Company Owned or Leased Cars
- Disability Payments
- Discount on Property or Services
- Nonqualified Stock Bonus Plan
- Partnership or S Corporation Distributions
- Scholarships/Fellowships
- Sick Payments
- Vacations (Free or Discounted)
- Educational Reimbursements
- Free or Subsidized Lodging
- Golden Parachute Payments
- Life Insurance Over $50,000 in Value
- Low interest loans
- Meal Allowances and/or Reimbursements (when away from home overnight)
- Memberships in Athletic Facilities
- Mortgage, house insurance and Real Property taxes
- Moving Expenses/Relocation Allowances
- Pension and Profit Sharing Plans
- Nonqualified Stock Option Plan
- Reimbursements for Loss on Sale of Houses Job Related Move
- Rent
- Severance Pay

## How Compensation is Reflected in the Books – IRS issue

- Compensation may be reflected on an employee’s tax return in various ways and appear in various line items
- Compensation may be received in cash or property and may not be called salary
- For example, besides officers’ salaries, compensation has been listed under:
  - Management fees
  - Consulting fees
  - Covenants not to compete
  - Commissions
  - Legal and professional fees
  - Rent or housing expenses paid, and
  - Other
- Also, one person’s compensation may be listed under more than one account in the general ledger

## Number of Employees at Issue

- The people receiving the compensation must be identified
- C-Corps with receipts over $500,000 will provide a breakdown of officer’s compensation on Schedule E, “Compensation of Officers”
- Note that this does not include compensation deducted elsewhere on the return, such as amounts included in:
  - Cost of goods sold
  - Elective contributions to a section 401(k) cash or deferred arrangement
  - Amounts contributed under a salary reduction Simplified Employee Pension Plan (SEP) agreement
- For tax-exempt entities, Form 990, Part VII, Section A, requires a listing of the compensation of officers, directors, trustees, key employees, other highly compensated employees and independent contractors
- For other tax returns or non-officer compensation, the breakdown must be done through the initial interview and standard IDR requests
- For example, an unusually large W-2 or 1099 may signal a Reasonable Compensation issue
Salary Survey Comparison

- Do a comparison of the compensation with general salary surveys
- Most salary surveys show a relationship between entity size and complexity and executive compensation

General Compensation Surveys

- National Compensation Survey
  http://www.bls.gov/ncs/
Sales Comparison

- Look at overall officers' compensation compared to company sales
- An issue may exist if the total officers' compensation is higher than the industry averages

Taxable Income Comparison

- Check the taxable income on the tax return
- IRS will add back the compensation in question
  - Does it make a significant change in taxable income
  - For corporations, if most of the profit is taken out of the corporation in compensation, it may indicate a portion of the compensation is a disguised dividend
  - For tax purposes, Reasonable Compensation is an allowable expense while dividends are not allowed as an expense
  - Usually, Officers' Compensation divided by Taxable Income (Before NOLs) is less than 1.0 for a mid-sized or large, mature business but will depend on the overall size of the company and standard industry practices
  - Once again, treat this as a broad indicator and as part of the risk analysis
  - Officers' Compensation as a percentage of Sales, like Officer's Compensation as a percentage of Taxable Income, can vary considerably, depending on the industry
  - In general, smaller firms and privately-held firms tend to pay a higher percentage of income as officers' compensation than do larger, publicly-traded firms

Subordinates Comparison

- Check on the relationships between the various salaries paid
- For example, in many cases where compensation is independently set, the second in command will have total compensation of 50% to 80% of the CEO's total compensation
- If the ratio is considerable lower than this, an issue may exist on the CEO's compensation
Other Survey Comparisons

- Other compensation survey information may be available from the taxpayer or other sources
- This information should be used in considering whether or not to develop an issue

Review

- WHAT IS REASONABLE COMPENSATION?
- Issue development begins with an understanding of what is compensation and what is reasonable compensation
- Reasonable Compensation is defined by Treas. Reg. § 1.162-7(b)(3) as the amount that would ordinarily be paid for like services by like organizations in like circumstances, and this standard is adopted in Treas. Reg. § 53.4958-4(b)(1)(ii)(A)
- Thus, the concept has two prongs:
  - Amount Test – focuses on the reasonableness of the total amount paid; and
  - Purpose Test – examines the services for which the compensation was paid.

Factors to Review

- Arm's Length Relationship
- This factor is one of the most important ones in evaluating the reasonableness of compensation
- A determination must be made as to whether the employer and employee negotiated the compensation at arm's length
- If the negotiation was at arm's length, the risk of excessive compensation is lower
- If the negotiation was not at arm's length, the risk of excessive compensation is higher and further factual development may be needed to establish the potential presence of a Reasonable Compensation issue
## Factors to Review

**Control by Related Parties**
- It must be determined whether related parties exercise control over the company and, if so, whether the existing relationships are improperly influencing compensation amounts to certain employees.
- This element is often present in cases involving excessive compensation.

## Factors to Review

**Availability of Comparable Services from a Third Party**
- Even if the employer could have obtained comparable services at a lower rate from someone other than the employee in question, this factor must then be considered further.
- The Valuation Analyst’s determination must focus on whether the amount paid to the employee is nonetheless reasonable.
- This factor often is closely related to a lack of arm’s length transaction.

## Evidentiary Issues

- Companies have the burden of showing that compensation is reasonable.
- The courts do not draw an adverse inference from the Service’s failure to offer evidence of comparables.
- However, it is often risky for the IRS to go forward based only on subjective arguments concerning reasonableness.
- Data on comparability generally requires expert testimony explaining its relevance before it will be given weight by the courts.
Data Sources

- Watson-Wyatt Salary Survey, Published annually
- RMA Annual Statement Studies, Published by Risk Management Association, published annually
- ERI (Economic Research Institute) Salary Survey, Updated Quarterly
- Top Executive Compensation, Published by the National Industrial Conference Board annually
- Executive Compensation and Taxation Coordinator, Published by Research Institute of America (RIA) annually
- Almanac of Business & Industrial Financial Ratios by Leo Troy, Published by Prentice-Hall annually
- General financial analysis of companies by industry organized by Standard Industry Code
- Industry Norms and Key Business Ratios, Published by Dun & Bradstreet Credit Services annually

The Information Document Request

- Please provide the following information for each officer:
  - 1. The role of the officer, director, trustee or key employee in the organization
    - a. Position(s) held;
    - b. Nature, extent, and scope of responsibility;
    - c. Duties (Marketing, Logistics; etc.), and hours per week in each discrete job area;
    - d. Total hours per week;
    - e. Material changes, if any, in each of the above over the last five (5) years;
    - f. Copies of employment, consulting and non-compete agreements in effect during the last five (5) years;
    - g. Professional qualifications

The Information Document Request

- Results of the officer’s efforts
  - a. Officer’s stated responsibility for organization’s inception and/or its on-going success;
  - b. The extent to which the organization’s actual success is attributable to the officer independent of his/her official responsibility;
  - c. Specific, significant contributions of the officer to the organization and the results of those contributions, both current and past
The Information Document Request

- Does the officer have any other business relationship with the entity other than their official internal role? If so, what is it?
- If the officer is also shareholder of the company or derives any income as a result of having an ownership interest, provide details as to his/her ownership interest in the company.
- Does the company carry “Key Person Insurance” on the officer and, if so, what is the amount of that insurance?

The Information Document Request

- Please provide copies of the audited financial statements (i.e., income statement, balance sheet, and statement of cash flows) for the organization for the past five years, including all footnotes, addenda, and appendices.
- If audited statements are not available for any or all of the past five years, please provide copies of the financial statements for book purposes for the past five years.
- Please provide data indicating the average number of employees and the number of employees at year end for each of the past five years.
- Please provide a brief explanation of the activities and functions of your organization.
- If there have been material changes in these activities and functions during the past five years, please provide a description of these changes.
- Identify the key competitors in the marketplace.
- Identify and describe local and national economic factors and conditions which are particularly important in affecting the financial condition of your organization.
- Which of the following would most accurately characterize your organization over the past five years: in expansion mode, stable mode, or downsizing?
- During the past five years, has your organization been subject to or the beneficiary of any extraordinary events? If so, please describe those events and their specific impact on your organization.

The Information Document Request

- What time of the year was the officer’s compensation determined?
- Were surveys, outside data, or outside expert reports used to determine the compensation amount?
- If so, please provide the following information:
  - a. What sources of data were used for the comparative analysis?
  - b. Explain how guideline entities were chosen.
  - c. How many entities were included in the survey where the guideline entities were chosen.
  - d. Please provide the analysis conducted, i.e., report, summary, etc.
The Information Document Request

• Did the compensation involve bonuses? If so, please provide the following information:
  – a. Provide the detail formulas for calculating bonus amounts
  – b. How were the formulas derived and who derived them
  – c. Is there any correlation between organizational performance, i.e. the number of new accounts, and officer’s compensation? If so, please provide the agreement
• Does the officer have access to an organization provided vehicle? If so, please describe the vehicle, the terms of the agreement and provide written documentation if available
• Does the officer have extra insurance benefits not available to non-executive employees? If so, please explain the terms in detail and the monetary amount of each
• Does the officer have access to any vacation property owned by the organization?
  – If so, what are the terms of the agreement? Were there any transfers of the property during the period under examination that involved the subject individual? If so, was that transfer an arms-length deal made at fair market value?

The Information Document Request

• Did the officer receive any loans from the organization? If so, what were the loan terms? Please provide copies of all loan agreements, including any loan modifications

The Information Document Request

8. Please provide a summary of the total compensation information for each of the identified officers in the following suggested format:

<table>
<thead>
<tr>
<th>Officer</th>
<th>Fiscal Year</th>
<th>Base Salary</th>
<th>Bonus</th>
<th>Contribution to Pension and/or Profit Sharing</th>
<th>Other Compensation and Fringe benefits</th>
<th>Total</th>
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<td>CEO</td>
<td>Year 1</td>
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TAXPAYER ARGUMENTS FOR REASONABLE COMPENSATION

ISSUES

• The taxpayer may rely on one or more of the following five points to support its position as to the appropriate level for current year compensation:
  – 1. Some of the compensation is for prior years’ under-compensation
  – Employee performs multiple jobs
  – “Hypothetical Independent Investor” test was satisfied
  – Employee personally guarantees company debt
  – Employee is a key person at the company or is a superior employee that deserves extraordinary compensation

Arguments

• Taxpayers often argue that a high level of current compensation is to make up for prior years in which the business was not able to properly compensate an employee. When an employee has, in fact, received inadequate compensation in previous years an increase over what might otherwise be the appropriate compensation level for the current year when taken in isolation may be reasonable
• In analyzing this argument, it is necessary to consider the substance of past events in line with the substantiation requirements
  – Whether the employee was actually underpaid in prior years based upon their performance
  – Did the company generate enough revenue to make reasonable salary payments in prior years
  – Did the employee as a shareholder enjoy an increase in retained earnings or an increase in the value of the company (for example, through stock options) in lieu of receiving compensation on a current basis (for example, as a salary)
  – Was the employee granted deferred compensation in prior years so that the total compensation paid for those years is reasonable
  – What would have been the effect on the corporate tax rate if a reasonable wage had been paid

Arguments

• An analysis of all of the prevailing facts and circumstances over time is required to make a proper determination
• This can be difficult and resource intensive, especially if a Valuation Analyst has inadequate data due to the passage of time
• Remember, the burden is on the taxpayer to substantiate deductions
Arguments

• MULTIPLE JOBS ("MANY HATS"/MANY HOURS)
  – Some taxpayers may justify high compensation based on
    the employees’ long hours and the extent of his or her
    responsibilities
  – Most high-level employees in a business work longer than
    a 40 hour work week
  – The Officer Compensation Report, by Panel Publishing,
    indicates that nearly one third of CEOs work in excess of 60
    hours per week during peak times and most work 45 - 60
    hours per week even during non-peak times
• The Cost Approach is often a good tool in assessing a
  taxpayer’s position

IRS Position

• The Service’s position on this argument has almost always involved
  one of these points:
  – a. Outside interests (Estate of Wallace v. Commissioner, 965 F.2d 1038
     (11th Cir. 1992)
  – Owenby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1325
     n.33(5th Cir. 1987) where the Court agreed with the Service’s position
     that compensation was unreasonable, but disagreed on amounts
     considered to be reasonable compensation for the years at issue
  – An employee is entitled to part-time compensation for part-time work
  – b. Non-aggregation of roles; functions vs. services. Ken Miller Supply,
     Inc. v. Commissioner, T.C. Memo. 1978-228) where the Court agreed
     with Service position that compensation was unreasonable, but
     disagreed on amounts considered reasonable compensation for years
     at issue
  – What is important is the nature and the scope of the services
    performed not the function implied by the job title

Personal Guarantee of Debt

• Taxpayers may take a position that the employee’s personal guarantee for the
  debt of the corporation is a factor that entitles the employee to a greater
  compensation level in a current tax year
• In certain situations, the courts have found that employee’s personal guarantee
  of the employer’s debt is a valid consideration in an overall compensation
  analysis
  – Owenby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315 (5th Cir. 1987) where the Court
    agreed with the Service’s position that compensation was unreasonable, but disagreed on
    amounts considered reasonable compensation for years at issue and
  – Owenby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315 (5th Cir. 1987) ¶ 36. To determine the
    relevant facts, the examiner should review the loan agreements
• Another issue in the personal guarantee of debt by officers or shareholders is
  whether the substance of the transaction involves debt or equity
• Reclassification of debt to equity is a highly factual issue and requires extensive
  factual development
• The Valuation Analyst must develop all relevant facts before making a
  determination that the guaranteed debt should be re-classified as equity and
  should coordinate the issue with Counsel as early as possible
Independent Investor Test

• The premise behind an Independent Investor Test is that an independent investor will demand a certain level of return on investment
• If the return received is at or above that level, the compensation being paid by the entity is presumptively reasonable, subject to rebuttal by the Service based on an analysis of all of the prevailing facts and circumstances
• In Guy Schoenecker, Inc. v. Commissioner, T.C. Memo. 1995-539, the Court found that it was not possible to determine what an "independent investor" would require as a return on an investment given the facts in the case and, as a result, the Court diminished the value of the compensation under the independent investor approach
• In that case, the Court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue

Key Person/Superior Employee

• KEY PERSON / SUPERIOR EMPLOYEE
  • A taxpayer may argue that the employee at issue is a key person, without whom the company would either cease to operate or greatly diminish in value
  • This argument usually arises in the employee-owner situation
  • Generally, in these circumstances, an issue may be present in how the taxpayer allocated payments to the employee-owner between compensation for services rendered (a deductible business expense) and compensation that is a return on capital or investment in the business (a dividend for a C corporation; or a distribution for an S corporation for which no deduction is allowable)
  • In making a determination on reasonableness of compensation paid, a Valuation Analyst should compare the owner-employee's compensation with a comparable non-owner employee’s compensation

Consideration of Penalties

• The Valuation Analyst should consider applying accuracy-related penalties in cases where compensation has been determined to be unreasonable
  – § 6662 includes penalties for negligence and substantial understatement of tax liabilities
  – Historically, these penalties have not been recommended because officers’ compensation has been listed as an item that is deemed disclosed under the applicable revenue procedures
  – However, a listed item will only meet the disclosure standard if taxpayers complete the forms and attachments in a clear manner and in accordance with the instructions
  – In addition, the dollar amounts entered on the forms must be verifiable
  – The taxpayer must be able to demonstrate the origin of the amount claimed and show that he entered it in good faith on the applicable form
Consideration of Penalties

- Revenue Procedure 2012-15 states, Form 1120, Schedule E, must be completed when required by instructions
- The time devoted to business must be expressed as a percentage as opposed to 'part' or 'as needed.'
  - In C.T.I. v. Commissioner, T.C. Memo. 1994-82, aff'd, 1732 A.F.T.R.2d (RIA) 1732 (3d Cir. 1995), the court upheld the substantial understatement penalty in a compensation case where the taxpayer had completed the Schedule E using the words "as needed."
  - In this case, the Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue

Consideration of Penalties

- The Revenue Procedure does not apply to "golden parachute payments" or to the extent that remuneration exceeds the $1 million limit
- In Thomas A. Curtis, Inc. v. Commissioner, T.C. Memo. 1994-15, the court upheld both the negligence and the substantial understatement penalties finding that the compensation was excessive and unreasonable, resulting in a partial disallowance of the deduction claimed
  - Here, the Court agreed with the Service's position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue
  - Reasonable Compensation is generally determined as a range rather than a specific number
  - If a taxpayer has paid compensation far above or below a reasonable range based on your valuation, research, and consideration of all relevant facts, you should consider applying penalties
- Beginning with tax year 2011, taxpayers must complete Form 1125-E, Compensation of Officers, and attach it to Form 1120 if they deduct expenses for employee compensation and have total receipts over $500,000

Let’s Deviate for a Moment
Treating Medical Insurance Premiums as Wages

- Health and accident insurance premiums paid on behalf of a greater than 2-percent S corporation shareholder-employee are deductible by the S corporation and reportable as wages on the shareholder-employee's Form W-2, subject to income tax withholding
- However, these additional wages are not subject to Social Security, or Medicare (FICA), or Unemployment (FUTA) taxes if the payments of premiums are made to or on behalf of an employee under a plan or system that makes provision for all or a class of employees (or employees and their dependents)
- Therefore, the additional compensation is included in the shareholder-employee's Box 1 (Wages) of Form W-2, Wage and Tax Statement, but is not included in Boxes 3 and 5 of Form W-2

Above the Line Deduction

- A 2-percent shareholder-employee is eligible for an above-the-line deduction in arriving at Adjusted Gross Income (AGI) for amounts paid during the year for medical care premiums if the medical care coverage was established by the S corporation and the shareholder met the other self-employed medical insurance deduction requirements
- If, however, the shareholder or the shareholder's spouse was eligible to participate in any subsidized health care plan, then the shareholder is not entitled to the above-the-line deduction. IRC § 162(l)

Health Insurance Purchased in Name of Shareholder

- The insurance laws in some states do not allow a corporation to purchase group health insurance when the corporation only has one employee
- Therefore, if the shareholder was the sole corporate employee, the shareholder had to purchase his health insurance in his own name
- The IRS issued Notice 2008-1, which ruled that under certain situations the shareholder would be allowed an above-the-line deduction even if the health insurance policy was purchased in the name of the shareholder
- Notice 2008-1 provided four examples, including three examples in which the shareholder purchased the health insurance and one in which the S corporation purchased the health insurance
Health Insurance Purchased in Name of Shareholder

- Notice 2008-1 states that if the shareholder purchased the health insurance in his own name and paid for it with his own funds, the shareholder would not be allowed an above-the-line deduction.
- On the other hand, if the shareholder purchased the health insurance in his own name but the S corporation either directly paid for the health insurance or reimbursed the shareholder for the health insurance and also included the premium payment in the shareholder’s W-2, the shareholder would be allowed an above-the-line deduction.
- The bottom line is that in order for a shareholder to claim an above-the-line deduction, the health insurance premiums must ultimately be paid by the S corporation and must be reported as taxable compensation in the shareholder’s W-2.

ACA Impact

- The Affordable Care Act (ACA) did not change the rules regarding the federal tax treatment of health and accident premiums paid for a 2% shareholder.
- However, for tax years after 2013, the ACA imposes penalties on the S corporation if the S corporation offers a health plan that fails to comply with certain market reform provisions, which may include plans under which the S corporation reimburses employees for the cost of individual health insurance premiums.
- The potential excise tax is $100 per day, per employee, per violation.
- Among the ACA market reform provisions is a requirement that a group health plan must not impose annual limits on essential health benefits.
- In Notice 2013-54, the IRS indicated that a health plan under which an employer reimburses employees for the cost of individual health insurance premiums (referred to as an "employer payment plan") will generally be treated as imposing a limit up to the cost of the individual policy premium.

ACA Impact

- The excise tax for failure to satisfy the ACA market reforms generally will not be imposed on an S corporation in the following two situations:
  - The S corporation provides medical benefits under a health plan that satisfies the ACA market reform requirements (for example, a group health plan that does not provide for reimbursement of individual policy premiums); or
  - No more than one active employee participates in the employer payment plan under which the S corporation reimburses the cost of individual policy premiums.
- The ACA market reform provisions do not apply to plans that cover fewer than two participants who are active employees. IRC § 9831(a)(2).
## Notice 2015-17 Transition Relief

- On February 18, 2015, the IRS issued Notice 2015-17, which provides transition relief for S corporations that sponsor employer payment plans covering 2-percent shareholders.
- Notice 2015-17 provides that, unless and until additional guidance provides otherwise, S corporations and shareholders may continue to rely on Notice 2008-1 with regard to the tax treatment of 2-percent shareholder-employee and their healthcare arrangements for all federal income and employment tax purposes.
- The Department of Labor and the IRS are contemplating publication of additional guidance on the application of the market reforms to a 2-percent shareholder-employee healthcare arrangement.

## Notice 2015-17 Transition Relief

- Until such guidance is issued, the excise tax under IRC § 4980D will not be asserted for any failure to satisfy the market reforms by a 2-percent shareholder-employee healthcare arrangement.
- Further, unless and until additional guidance provides otherwise, an S corporation with a 2-percent shareholder-employee healthcare arrangement will not be required to file IRS Form 8928 (regarding failures to satisfy requirements for group health plans under chapter 100 of the Code, including the market reforms) solely as a result of having a 2-percent shareholder-employee healthcare arrangement.
- Note: To the extent that a 2-percent shareholder is allowed both the above-the-line deduction and the premium tax credit, Rev. Proc. 2014-41 provides guidance on computing the deduction and the credit.

## Fewer Than Two Participants Who Are Current Employees Exception

- Market reforms do not apply to plans that cover fewer than two active employees.
- Notice 2015-17 explains that if the S corporation employs more than one employee, where the additional employee is a spouse or child of the shareholder and all employees are covered under a reimbursement arrangement with family coverage under the same plan, the arrangement would be considered to only cover one employee and would not be subject to the market reforms.
- As such, an S corporation with only family employees covered by the same plan may continue to reimburse for a family plan and fall under the “fewer than two participants who are current employees” exception to the market reforms.
Fewer Than Two Participants Who Are Current Employees Exception

- With respect to coverage of employees who are not 2-percent shareholders, Notice 2015-17 explains that if an S corporation maintains more than one reimbursement arrangement covering both 2-percent shareholder-employees and non-2-percent shareholder-employees, the arrangements would be considered a group health plan and would not be exempted under the “fewer than two participants who are current employees” exception to the market reforms.
- Such a plan would generally fail to satisfy the ACA market reform requirements and thus may trigger the excise tax under IRC § 4980D with respect to the non-2-percent shareholder employees.
- However, Q&A-1 of Notice 2015-17 provides that no penalties under § 4980D will be assessed under such an arrangement until at least June 30, 2015.

CALT Website

http://www.calt.iastate.edu/

Tour of the CALT Website
Changes to the Iowa Farm and Urban Tax Schools

- It has been a season of change – this is good
- Our Fall and Winter Tax Schools are changing – this is good
- September 9, 2016 – Farm Tax Seminar
- All Farm issues All day
- For the winter tax schools, farm issues may come up but we will center on other issues important to your practice, including ethics for early bird attendees at some sessions

Please Welcome
Phil Harris

- Professor, Agricultural and Applied Economics – University of Wisconsin-Madison
  - J.D., University of Chicago, 1977
  - M.A., Economics, University of Chicago, 1975
  - B.S., Economics, Iowa State University, 1973
- His research program focuses on business and tax planning for agricultural producers
- The program includes information on the choice of entity for organizing a farm business and for transferring a farm business to the next generation
- Income, estate and gift tax consequences as well as non-tax issues

Phil Harris

<table>
<thead>
<tr>
<th>Phil Harris</th>
<th>CALT Speaker</th>
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<tbody>
<tr>
<td></td>
<td>September 9, 2016 Farm Tax Seminar</td>
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<td></td>
<td>The session will also be available via webinar</td>
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<td></td>
<td>Instructor – Farm and Urban Tax School</td>
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<td></td>
<td>November 21 – 22 – Waterloo</td>
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<td>December 12 – 13 – Ames</td>
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Fall Tax Schools

• Though they are named the Farm and Urban Tax Schools the schools cover more than farm issues
• Common return issues for all kinds of returns are covered
• All kinds of business entities
• Problematic issues
• Sometimes we even get into issues that you many encounter only once or twice a year or tax season
• The Tax Schools are a blend of diverse topics of interest to all tax professionals
• This year: New instructors with diverse backgrounds
• Your adventure awaits at Iowa State’s Center for Agricultural Law and Taxation

Farm and Urban Tax Schools 2016

• November 2, 2016 to December 13, 2016
• 8 Locations in Iowa and Online Webinar
• Save the Date for the 2016 Annual Farm and Urban Income Tax Schools
• The program is intended for tax professionals and is designed to provide up-to-date training on current tax law and regulations
  – November 2-3: Maquoketa
  – November 7-8: Red Oak
  – November 9-10: Sheldon
  – November 14-15: Mason City
  – November 17-18: Ottumwa
  – November 21-22: Waterloo
  – December 5-6: Denison
  – December 12-13: Ames and Live Webinar

September Farm Tax School
Navigating Changing Times

• September 8, 2016 to September 9, 2016, Ames, Iowa and Online
• Attend any one day or both days, either in-person or online! Company discount for 3 or more individuals from the same employer!
• Ag Law Seminar, September 8
  • Our Thursday seminar will offer practical, interesting information you can immediately apply in your practice or ag-related business. You’ll leave with forms and other tools to help you more efficiently serve your ag clients.
• Farm Tax Workshop, September 9
  • Our Friday seminar will be a comprehensive one-day farm tax workshop designed to equip tax practitioners with the tools they need to prepare farm income tax returns, from the simple to the complex.
• Online Registration: https://goo.gl/pdITK5
Registration Fees

- **Early Rate - Registered on/ by August 31**
  - Attend in person or watch from your computer
  - Any one day: $200
  - Both days: $350
  - Company Discount: $10 discount per individual if 3 or more are registered from the same employer - this is available for either on-site or online attendance

- **Late Rate - Registered after August 31**
  - Attend in person or watch from your computer
  - Any one day: $220
  - Both days: $370
  - Company Discount: $10 discount per individual if 3 or more are registered from the same employer - this is available for either on-site or online attendance

Continuing Education

- **Ag Law Seminar (September 8)**
  - Continuing Legal Education (CLEs) - 7 hours (including one hour of ethics)
  - Others Professional Education (CPEs) - 7-8 hours (including one hour of ethics)

- **Farm Tax Workshop (September 9)**
  - Continuing Legal Education (CLEs) - 7 hours (including one hour of ethics)
  - Others Professional Education (CPEs) - 7-8 hours (including one hour of ethics)

Speakers

- **Ag Law Seminar**
  - Shannon Ferrell, Associate Professor, Agricultural Economics, Oklahoma State University
  - Eldon McAfee, Shareholder, Brick Gentry P.C.
  - Erin Herbold-Sawalwef, Shareholder, Brick Gentry P.C.
  - Julia Vyskocil, Shareholder, Brick Gentry P.C.
  - Pat Dillon, Dillon Law P.C.
  - Professor Neil Hamilton, Director of Drake Law School Agricultural Law Center
  - John Baker, Iowa State’s Beginning Farmer Center Administrator
  - Jennifer Zwagerman, Associate Director of Drake Law School Agricultural Law Center
  - Kristine Tidgren, Assistant Director for the Center for Agricultural Law & Taxation

- **Farm Tax Workshop**
  - Philip E. Harris, JD, University of Wisconsin professor
  - Kristy Mather, Tax Specialist with the Center for Agricultural Law & Taxation
Farm Tax Seminar Topics

- Legislation Update: The Protecting Americans from Tax Hikes Act of 2015 (PATH Act) and the Consolidated Appropriations Act, 2016 (CAA of 2016)
- Income Issues
  - Constructive Receipt
  - Installment Sale of Goodwill
  - Hedging and Other Marketing Transactions
  - Farm Income Averaging
  - Farm vs. Nonfarm Income
  - Exemptions
  - Sale vs. Lease of Equipment by a Retiring Farmer
  - Conservation Reserve Program Payments
  - Income in Respect of a Decedent
  - Reporting Property as Self-rental on Schedule E (Form 1040)
- Deduction Issues
  - Tangible Property Regulations
  - Lease vs. Purchase of Farm Equipment
  - Segregating Fertilizer Costs
  - Domestic Production Activity Deduction
- Start Up Expenses

Farm Tax Seminar Topics

- Entity Issues
  - Partnership Formation and Contributed Assets with Debt in Excess of Tax Basis
  - Guaranteed Payments
  - Qualified Joint Ventures
  - Issues for Farmers with Multiple Entities
  - Miscellaneous Farm Issues
  - Material Participation
  - Capitalization of Preproduction Expenses
  - Farm Inventory
  - Hobby Losses
  - Gift of Commodities
  - Valuation of growing crops
- Cases and Rulings: A summary of rulings and cases from the past year that affect farmers

Accommodations

- Quality Inn & Suites Starlite Village Conference Center
- 2601 East 13th Street, Ames, Iowa
- Discounted overnight rooms are available for $89.00 per night (for the dates of September 7, 8 and 9)
- Call the hotel at 515-232-9260 and mention you are attending the Iowa State University September Seminars
### Summer Webinars

- Travel, Meals and Entertainment
- Preparing for a Gambling Audit
- Your Client Dies, What’s Next?
- Innocent Spouse
- Above the Line Deductions
- Roth IRA’s
- Net Operating Losses
- The Portability Election
- IRS Return Preparer Penalties Overview
- Miscellaneous Income
- New Developments

### Summer Webinars

- Tax Research with Limited Resources
- Injured Spouse
- IRS Representation
- Inventory Issues
- Preparing for an IRS Audit
- Appeals – How to Write Your Appeals Request
- Start Up Costs
- Hobby Losses

### Beginning Tax Preparers Class

- CALT is working on offering a basic class for NEW tax preparers this fall in October
- The week long webinar will cover the basics an individual needs to know such as:
  - Requirement to file
  - Dependents
  - Filing Status
  - Itemized deductions
  - Education Credits
- Other issues a first or second year preparer needs to know as well as a refresher for others who need to brush up on issues
- The class will be a week long or more and will be offered at a special rate
The Scoop

- Throughout the filing season two Scoops will be held on Scoop Dates
  - 8:00 – 8:30 am Central time
  - 12:00 – 12:30 Central time
- This assists with accommodating our west coast practitioners
- The same information will be shared at both sessions
- You have the option of registering for whatever session suits your schedule
- https://www.calt.iastate.edu/calendar-node-field-seminar-date/month

Future Scoop Dates

- July 6, 2016
- July 20, 2016
- August 24, 2016
- September 7, 2016
- October 5, 2016
- October 19, 2016
- November 16, 2016
- December 14, 2016
- http://www.calt.iastate.edu/calendar-node-field-seminar-date/month

The CALT Staff