THE REASONABLE COMPENSATION JOB AID

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Although the IRS's Reasonable Compensation Job Aid is more than two years old, it offers a fairly comprehensive compilation of the critical matters to consider in addressing reasonable compensation issues.

Reasonable compensation is the topic of the second Job Aid for IRS Valuation Professionals[1] issued by the IRS on 10/29/14.[2] Although "Reasonable Compensation, Job Aid for IRS Valuation Professionals," (Job Aid) was first released more than two years ago, surprisingly, little has been written about the content of this document. However, expanded analysis and due consideration of this Job Aid is not only warranted, but prudent, since the effects of reasonable compensation determinations are felt daily by those involved in the practice of business valuation as well as income taxes.

Background

The issue of reasonable compensation has been a longstanding area of controversy for taxpayers and those practicing before the IRS. Historically, and dating back to nearly the inception of the federal income tax law, the issue has evolved from challenges in the income tax arena related to regular "Subchapter C" corporations. The contested matter most often at issue is whether those amounts taken as income tax deductions (and thereby reducing corporate taxable incomes) under the guise of compensation payments to employees/shareholders under Section 162, constitute "ordinary and necessary" expenses that are "reasonable in amount." To the extent that such challenges find amounts paid as compensation to be unreasonable, the IRS generally argues that any excess is a taxable dividend. Such dividend income constitutes ordinary taxable income to the recipient just as the previously-characterized compensation would, but the amount paid as a dividend would no longer serve as a tax deduction in calculating the corporation's taxable income. Thus, the IRS gained the additional income tax associated with the loss of the deduction to the corporation, while preserving the income tax paid by the recipient.

In more recent years, the income tax reach of the reasonable compensation discussion has expanded into two additional areas of challenge. These two circumstances and areas of dispute are also rooted in the federal income tax regime and present differing paths by which the issue must be evaluated. Both of these are discussed in the Job Aid.

Reasonable compensation in the determination of S corporation pass-through income. The first expanded issue relates to the level of compensation paid to S corporation employees/shareholders. Under the S corporation rules currently in place,

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pass-through income subjected to income tax at the shareholder level is not subject to self-employment tax and FICA tax, while amounts paid as compensation are subject to employment taxes. This tax regime leads to taxpayer attempts to minimize employment compensation subject to the additional taxes while allowing the employee/shareholder to take larger amounts of pass-through income not subject to the employment taxes. Under the current S corporation tax rules, the employee/shareholder can then take distributions out of the S corporation to the same level as the taxable income reported on his or her tax return, essentially without any further income tax. Thus, the lowest possible wages in these circumstances drive the planning strategy and can result in substantial tax savings.

The economic effect of such strategies is that the employee/shareholder is in the same position in both cases, excepting the employment taxes (which are avoided due to low compensation). In these cases, the IRS is looking for the employee/shareholder to be paid at a reasonable level of compensation, which would be subjected, then, to the appropriate employment taxes. Thus, the S corporation issue is one of moving compensation expense higher, rather than lower.

Private benefit and tax-exempt entities. The second area of more-recent scrutiny involves tax-exempt entities and the Code provisions governing these organizations. A separate section of the Job Aid addresses reasonable compensation in the context of entities filing Forms 990, Return of Organization Exempt From Income Tax, because the IRS has a vested interest in these organizations. The Code rules for monitoring tax-exempt entities generally prohibit payment beyond "reasonable compensation" to "disqualified" individuals and allow for the assessment of excise taxes and penalties on excess amounts paid. When excessive compensation is found to have been paid to a "disqualified" individual, the payment is characterized as private inurement, simply meaning that certain amounts raised through the public's generosity have been diverted from the exempt mission of the organization.

Purpose of the Job Aid

Interestingly, the Job Aid is titled as being prepared for valuation professionals. However, that same title page notes that the document might also be helpful to revenue agents and other IRS field service personnel. Thus, the Job Aid serves the dual function of being designed and produced to help IRS employees in both the valuation and income tax arenas.

As with the "S Corporation Job Aid" and the "Job Aid on Discounts for Lack of Marketability,[3]" issued by the IRS, the Reasonable Compensation Job Aid is not authoritative. In addition, the document notes on every page that, "The Job Aid is not Official IRS position and was prepared for reference purposes only; it may not be used or cited as authority for setting any legal position." Further, a full disclaimer notes that "This Job Aid is not an official pronouncement of law, and cannot be used, cited, or relied upon as such."

From a tax practitioner's position (and equally applicable to a valuation practitioner), the Job Aid should be viewed as offering nothing more than insight into the IRS's current thinking on this nebulous topic. As such, no weight need be given to the document as authority for, or against, any amount previously deducted as compensation or set forth as reasonable in a business valuation. The determination in every such challenge, as acknowledged in the *Disclaimer* section in the Job Aid, is ultimately predicated on the specific facts and circumstances surrounding each particular situation. Thus, while it is important and helpful for a practitioner to fully understand the content of the Job Aid, he or she must remember that each determination of reasonableness will vary based on the facts and circumstances inherent in the particular situation.

Guidance in determining reasonable compensation

What, then, is the purpose of the Job Aid? As with the previous two, the document is intended to serve as a guide for IRS valuation professionals in addressing the reasonable compensation issue in both for-profit and not-for-profit entities. One interesting aspect of the language in the *Disclaimer* section is the reference to the issue [reasonable compensation] being [one that is both] "factually intensive" and requiring "professional judgment." Such language infers that the answer demands careful analysis and more than a cookie-cutter approach to determining reasonable compensation. However, as was the case with the previous Job Aids, the later language and

[1] Links to the IRS Job Aids can be found at www.irs.gov/businesses/valuation-of-assets.

[2] Information about the other Job Aid issued on that date can be found in, Grossman, "Valuation of Non-Controlling Interests in Business Entities Electing to be Treated as S Corporations for Federal Tax Purposes" 19 *Valuation Strategies* 16 (September/October 2015).

[3] Job Aid for IRS Valuation Professionals, "Discount for Lack of Marketability," 9/25/09.

examples in this Job Aid seem to imply otherwise by providing methodologies for computing reasonable compensation. Care must be taken to ensure that IRS personnel presenting their determinations, as well as those prepared by taxpayers and their experts do not base those determinations on identically, or nearly identically, on methodologies set out in the examples of the Job Aid.

The "Reasonable Compensation Job Aid" is far more substantial than its counterpart released on the same date, the "S Corporation Job Aid," and, as such, may serve as a more comprehensive and useful tool for practitioners. Consisting of 25 pages of guidance, with an additional 26 pages of Appendices, the "Reasonable Compensation Job Aid" succeeds nicely in compiling the primary information that practitioners should look to as relevant in any determination of reasonable compensation.

The Job Aid serves the dual function of being designed and produced to help IRS employees in both the valuation and income tax arenas.

Organization of the Job Aid

The information in the Job Aid (without consideration of the Appendices) is partitioned into six separate sections, as follows:

1. Purpose, Background and Case Coordination.
2. Identifying a Reasonable Compensation Issue.
3. Developing Reasonable Compensation Issues.
4. Taxpayer Arguments for Reasonable Compensation Issues.
5. Consideration of Penalties.
6. Focusing Specifically on Not-for-Profits.

Additionally, the Appendices offer several helpful resources for further reading and provide examples of certain mechanical means by which determinations of reasonable compensation might be undertaken. The Appendices also include a compendium of cases deemed relevant by the Service in addressing these issues from differing points of challenge and defense.

Note, however, the amount of commentary, analysis, and judicial history accorded these matters far exceeds the content of the information noted in the Job Aid. Tax and business valuation practitioners would be wise to read and fully understand the Job Aid content. However, they also need to appreciate that the issues can be very complex, and substantive reading and analysis beyond the content of the Job Aid will better prepare for an optimum defense of any tax authority challenge, including the IRS.

The following discussion addresses each section of the Job Aid and how the information set forth in that section might be best used in the context of making such determinations from the perspective of tax and valuation professionals.

Section I: Purpose, Background and Case Coordination. Just two pages in length, the section serves the function of explaining those items enumerated in the title. Noteworthy for business valuators, in the "Purpose" subsection, is the comment that the Job Aid addresses the market, income, and cost approaches, with the market approach being the "most commonly used method" [for determinations of reasonable compensation].

The "Background" subsection requires no further discussion and simply sets forth a rather brief exposé on the history of the matter as noted at the beginning of this article. However, the subsection again notes that "The Courts favor a 'market approach' when determining reasonable compensation." The subsection concludes that a number of other approaches have been developed to determine reasonable compensation essentially due to the challenges in correctly applying the market approach.

Finally, in the "Case Coordination" subsection, the internal function of the IRS and the need for a coordinated team approach is discussed. Understanding exactly how this team comes together and how the involvement of personnel within the different Service divisions is coordinated should serve to help taxpayers and practitioners better prepare for defense of their positions.

The one glaring observation taken away from a careful review of this first section is the IRS's assumption that the reasonable compensation determination merits the same factual, analytical, and judgmental assessment whether the issue is related to an income tax issue or a business valuation issue. While it does appear from careful reading that the Job Aid is primarily focused on the determination of reasonable compensation for income tax purposes, there seems to be no direct commentary on making economic compensation adjustments in the context of business valuation.

The author is not wholly convinced that the two issues are identical or that the appropriate level of compensation might not vary between the two applications. While there are, of course, a number of similarities between the two determinations, economic compensation on a go-forward basis as included in a discounted future cash flows computation under the income approach is likely to be different to some degree than that level of compensation deemed to be reasonable under income tax rules.

Section II: Identifying a Reasonable Compensation Issue. The second section of the Job Aid is much more substantive and is segregated into three broad subsections. These subsections essentially provide practitioners with a map of the process by which the IRS identifies and, ultimately, intends to address reasonable compensation from its end. The three subsections are titled,

- Cautions.
- Where Reasonable Compensation Issues Are Found.
- Steps to Identify Reasonable Compensation Issues.

Cautions. This subsection is interesting in that the Job Aid authors appear to be attempting to take emotion out of the challenge process and interject objectivity. Phraseology such as "reasonable compensation may be a sensitive issue," and "avoid personal judgments about what a specific individual's efforts seem to be worth to you" clearly address a problem encountered by this author on numerous cases. Personal opinions from IRS examination team members as to what someone's reasonable compensation should be are not relevant although, human nature being what it is, are sometimes at the heart of the issue, at least initially.

The subsection also advocates for discretion and that the valuation analyst should not tell anyone "how much an employee may be compensated;" rather, the term "reasonable" compensation should be used. Also, the issue should be restricted to the "U.S. Federal tax implications that only a reasonable amount is deductible as compensation." Additionally, the text notes that reasonable compensation might best be described as a range rather than a set number, because of the "interpretive nature of the issue." Reflecting an understanding of the issue, the subsection acknowledges that "valuation experts may arrive at various amounts for reasonable compensation."

Another issue addressed in this subsection is the validity of comparing an employee's compensation with that of a commissioned salesperson as a basis for higher compensation. Finally, the importance of a thorough interview with the employee whose compensation is under consideration is emphasized.

Throughout the "Cautions" subsection, the overlay of the term "valuation analyst" with U.S. federal income tax law and the allowable income tax deduction for reasonable compensation seems to cloud the issue. The text implies that the theory from the IRS for the determination of reasonable compensation is the same for both income tax and business valuation purposes.

Where Reasonable Compensation Issues are Found. The second subsection lists typical cases involving family businesses; closely-held businesses; subchapter S corporations; foreign corporations; acquisitions and divestitures/sales; prior-year compensation adjustments; and no-interest or low-interest loans. The perceived abuses within each of these typical cases are explained within the subsection in the context of a federal income tax challenge as to deductibility of the compensation in question.

The family business and closely-held business cases are some of the most typical challenges that end up in the judicial system. The clear and obvious circumstances that might lead to challenges from the Service include "unreasonable compensation" paid to children or related parties, as well as "unreasonable compensation" paid to employees who are also shareholders. In signing off on family business and closely-held business returns, care should be taken to ensure that compensation taken as a deduction is valid and properly determined and documented.

S corporations are simply those cases discussed earlier when employees/shareholders attempt to minimize employment taxes by virtue of taking less than reasonable compensation for personal services. In the area of foreign corporations, the IRS is essentially looking for abuses in the manner in which compensation is allocable in and out of country. Such abuses, if identified, are correctable under Section 482, Allocation of Income and Deductions. This provision affords the IRS wide discretion to reallocate deductions to fairly present income.

Compensation issues in acquisitions and divestitures generally revolve around transaction costs that are required to be capitalized, but, instead, have been recast as compensation for personal employee services or consulting services to allow for a current tax deduction. Finally, the issue of adjustments for prior year under-compensation needs no explanation here nor does no interest or low interest related party loans.

Steps to Identify Reasonable Compensation Issues. The final subsection notes, importantly, that no one single step is determinative of reasonable compensation. It directs the valuation analyst to give consideration to a number of issues, including:

- Process for setting compensation.
- Tax return information.
- Number of employees at issue.
- Salary survey comparison.
- Sales comparison.
- Taxable income comparison.
- Subordinates comparison.
- Other survey comparisons.

It is clear from this subsection that the IRS is heavily influenced by comparative analysis. Throughout these challenges, the Service often looks to compare the compensation under examination to industry data, business sales, and revenue as a percentage of taxable income, as well as to subordinates' compensation. Each of these comparisons is discussed further in this subsection of the Job Aid.

When this author has defended compensation deductions on tax returns, excepting industry surveys (with geographic considerations), the relevancy of any of these comparisons is questionable at best. However, the relevancy of the comparisons is not a barrier to their introduction by the IRS. As listed in this document, these comparisons will likely continue as one avenue of attack to which taxpayers will have to respond to preserve their deductions.

Business valuation and income tax practitioners must be attuned to the sufficiency and relevancy of the comparison sources. For example, when comparisons are proposed to industry data, consideration must be given to the sufficiency of similarity between industry guideline companies and the subject, just as would be required in the context of applying the market approach in business valuation.

In signing off on family business and closely-held business returns, care should be taken to ensure that compensation taken as a deduction is valid and properly determined and documented.

Section III: Developing Reasonable Compensation Issues. Section III of the Job Aid is the most lengthy of the different sections, encompassing nine pages. It is intended to aid IRS personnel in understanding issues ranging from the technical aspects of reasonable compensation to the valuation (determination) of reasonable compensation.

As each particular challenge to reasonable compensation is facts-sensitive, it stands to reason that the initial aspects of this section speak to gathering and analyzing facts. The section notes, importantly, that, "reasonable compensation is, at its base, a business valuation problem where what is being valued is an employee's services and the attributes that he or she brings to a company."

Definition of Reasonable Compensation. The critical elements of understanding what exactly is compensation, and then, what is reasonable compensation, is defined by reference to Reg. 1.162-7(b)(3) as the "amount that would ordinarily be paid for like services by like organizations in like circumstances." Understanding this definition is critically important to defeating an IRS challenge to compensation deductions. The key aspects of the definition are "like services" by "like organizations" in "like circumstances." Each of these terms is interpretive and should always leave room for distinguishing particular fact patterns in any specific case. As noted above, it has been this author's experience that an examination of reasonable compensation rarely accorded the required effort and necessary resources to make an absolute determination that sufficient similarities exist to make definitive assessments of "likeness." Obviously, such a term can be extremely arbitrary and leaves room for alternative arguments.

Two prong test. As a result of the technical definition set forth in the regulation, the reasonable compensation test has evolved along two distinct prongs. The first of these is an "Amount Test," which focuses on the reasonableness of the total amount paid. The second part is a "Purpose Test," which examines the services for which the compensation was paid.

The first prong is the issue that most often becomes contentious in a reasonable compensation dispute. The rare exceptions are those few instances in which the actual compensation payments made are being challenged as lacking a compensatory intent. As the Job Aid notes, however, "intent is subjective and difficult to prove." As such, the IRS does not generally begin reasonable compensation actions based on the second prong (the "Purpose Test," or intent).

Factors to Consider in Assessment of Reasonable Compensation. This section sets out factors that should be considered in conjunction with the development of a reasonable compensation assessment. The list includes:

- The employee's qualifications.
- The nature, extent, and scope of the employee's duties.
- The employee's background and experience.
- The employee's knowledge of the business.
- The size and complexity of the business.
- The time devoted by the employee to the business.

- The economic conditions generally and locally.
- The character and responsibility of the employee.
- Whether the compensation is pre-determined based on activities to be performed or not determined until the end of the year.
- Amounts paid to the employee in prior years.
- The salary policy of the taxpayer as to all employees.
- The amounts similar-size businesses in the same area pay to equally-qualified employees for similar services.

The listing is noted in the Job Aid as based on statute, associated regulations, and several judicial decisions.[4] The approach of evaluating each of these factors has evolved over time to become known as the "multi-factor" approach. Unfortunately, a substantial amount of the factors tend to be subjective.

Importantly, the Job Aid notes that the listing may not be all-inclusive, and that other factors may be relevant in a particular case. Also, practitioners must remember that no single factor is controlling, and that the final decision will rest on all of the facts and circumstances of any particular challenge. This section goes on to discuss factors specific to the particular employee under examination, the employing organization, and the compensation itself.

Employee-specific factors. The factors relating to the employee are fundamental and embrace core concepts set forth in the listing set out above. The key additional factors in this category are the presence (or not) of an arm's-length relationship and whether there is related party control. Compensation based on independent and objective management and ownership will go a long way in defeating challenges based on the reasonableness of that compensation.

The balance of the factors specific to a particular employee include an assessment of the availability of comparable services from a third party; the nature of the employee's duties; the employee's background and experience; the time devoted to the job; and the employee's earnings history.

Employer-specific factors. The factors specific to the employing organization reflect the IRS's proclivity to lean on comparisons. These factors include the salary scale of others in the same line of business, the size of the organization, and the salary scale of employees generally. As noted earlier, the key to defeating an IRS challenge based on these comparisons is to successfully argue that the comparison points are not sufficiently similar to the subject company.

Compensation-specific factors. The factors listed that are specific to the compensation itself include the criteria on which the compensation was determined; the historical setting of salary many years in advance of the actual performance of services; the substantiation of duties performed and salary paid; the presence of any contingent compensation; and the presence of the evidentiary burden. As with all tax deductions, the burden of proof most often falls on the taxpayer to adequately demonstrate entitlement to the deduction.

The balance of the section goes on to set a protocol for the factual development of a reasonable compensation case. In that it sets this process, it would serve practitioners well to ensure that they have a full understanding of the means by which the case will be developed.

Factors Developed by the Courts. The final "pre-valuation" subsections of Section III address those factors developed by the courts in resolving reasonable compensation cases. The judicial factors set forth in the Job Aid broadly overlap those previously discussed and include the employee's role in the company; the external comparison of the employee's salary with those paid by similar companies for similar services; the character and condition of the company; the presence of any potential conflict of interest in relationship of the employee to the corporation; and the internal consistency in the company's treatment of payments to employees.

Analysis of financial performance of company. While beyond the scope of the Job Aid, the document notes that the company's financial performance must be considered and compared to the industry and to its competitors to show whether the company in which the employee works is below average, average, or above average. The assessment can then be extrapolated to determine whether the compensation should be selected from the lower, middle, or upper end of a range.

The document sets out additional reasons why the financial analysis is necessary, including the need to identify similar companies and to explain differences in compensation between competitors based on financial performance.

This author feels strongly that the reasonable compensation issue is inherently integrated with financial performance of the com-

[4] *Mayson Manufacturing Co.*, 178 F2d 115, 38 AFTR 1028 (CA-6, 1949); *Owensby & Kritikos, Inc.*, 819 F2d 1315, 60 AFTR2d 87-5224 (CA-5, 1987).

pany. The courts have noted this repeatedly, most recently in *H. W. Johnson, Inc.*[5] This case, which will be addressed further in this article, noted that the long-term success of the company was attributable to the taxpayers' efforts. Thus, the compensation was deemed reasonable, and the deduction allowed in full. *H. W. Johnson* confirms the required emphasis on the underlying financial performance of the employer and the contributions to the success of the employer by the affected employee.

General Approaches to Valuation. Section III concludes with a brief discussion of the three general approaches to valuation and how they can be applied in reasonable compensation cases. The Job Aid notes that the market, income, and cost approaches are applied and reconciled to determine reasonable compensation. The Appendices later include examples of a reasonable compensation determination under the market and income approaches.

Compensation based on independent and objective management and ownership will go a long way in defeating challenges based on the reasonableness of that compensation.

Market approach. The market approach, set out in the early part of the Job Aid as that approach most often used in the determination of reasonable compensation, is addressed first. The Job Aid directs that the taxpayer's compensation must be compared to others similarly situated in the industry. The valuation analyst must determine how much compensation would be paid for this same position, held by a non-owner in an arm's-length employment relationship, at a similar company.

To answer that question, the Job Aid notes numerous sources of third-party market and financial information that may be used in applying the market approach. Included in this list (not all-inclusive) are general industry surveys; salary surveys by industry; Securities and Exchange Commission filings; and private company compensation information.

Income approach. The income approach is introduced as being based on the "independent investor test," which seeks to determine whether an independent investor would be satisfied with his or 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. Obviously, and as the Job Aid points out, the income approach generally can be applied correctly only when the fair market value (FMV) of the company is available for each year that compensation is being challenged. Thus, a business valuation is usually required to argue reasonable compensation under the income approach. The valuation is required to allow measurement of total investment return to the investors.

This approach integrates the reasonable compensation finding with the actual financial performance of the company. It stands to reason that leadership at exceptionally-performing companies would be paid proportionately more than those at average-performing companies or below-average-performing companies. There is no argument that theoretical investors would generally prefer to pay management less and obtain higher returns. However, given adequate rates of return, the idea of replacing the employee in question with a lower-cost employee at the risk of compromising future returns is illogical from an economic and risk perspective.

Interestingly, the Job Aid contains language in the subsection on the income approach suggesting that the independent investor test creates a rebuttable presumption that an employee's compensation is reasonable if the investors obtain a far higher return than they had any reason to expect. The origin of this position evolves from *Exacto Spring Corp.*[6] The court opined in that case that rather than rejecting the multi-factor approach (where numerous subjective data as listed earlier are evaluated), some courts had taken a broader view approach, reasoning that the independent investor test is the "lens" through which the various factors are viewed.

The courts do not seem to require a far higher return to justify reasonable compensation. The fact that investors receive an acceptable return based on investment risk is, and should be, acceptable. In *H.W. Johnson*, the IRS focused on the question of whether a reasonable investor would have agreed to the questioned compensation, arguing that the return on investment that was actually produced would have been insufficient to please a theoretical independent investor. In the case, the court had a clear preference for the analysis prepared by the taxpayer's expert of the rate of return that would have been expected in the industry. However, that analysis concluded that the employer company's rate of return was, in fact, below the industry average for both of the tax years in question.

[5] TCM 2016-95.

[6] 196 F.3d 833, 84 AFTR2d 99-6977 (CA-7, 1999).

As illustration of the rate of return, the subject company's rate of return was .3% below the industry average (10.2%) in the first year under examination, and 1.9% below the industry average (9%) for the second year under examination. Even so, the court did not find the IRS's arguments regarding rate of return persuasive, noting that the Service provided no authority for the proposition that the required rate of return on equity for purposes of the independent investor test under the income approach must significantly exceed the industry average rate of return. The opinion states that, "in applying the independent investor test the courts have typically found that a return on equity of at least 10% tends to indicate that an independent investor would be satisfied and, thus, payment of compensation that leaves that rate of return for the investor is reasonable."

The language in this case marks the first time that a threshold rate of return has been indicated by the court, though lower rates of return have carried the day in the past. The court's finding is critically important in that it provides practitioners and taxpayers a target rate of return to consider in the determination of whether compensation paid is reasonable. This is an important, taxpayer-friendly decision and a must-read for all reasonable compensation defenses based on the independent investor test.

The IRS acknowledges the validity of the independent investor test but, again, seems to prefer the market approach as a better alternative for determining reasonable compensation. In the author's view, the independent investor test is that primary method under the income approach that is most correct and company specific in making that determination. Thus, it is inherent in the defense of a reasonable compensation challenge that the arguments begin with carefully proving this test.

The difficulty in applying the independent investor test is in the practical procedures, which essentially require a business valuation of the employer company for each year under examination. However, if the FMV can be determined, return on equity can easily be calculated.

Cost approach. The cost approach is also addressed in this subsection. As set forth therein, the cost approach breaks or bifurcates the duties of the employee into its components such as administration, accounting, finance, marketing, engineering, etc. Once the compensation cost of each area of responsibility is determined, the amounts are simply totaled to arrive at a total cost to replace the duties/services of the employee under examination for the amount of time used for each function.

The Job Aid notes that a weakness in the cost approach is the difficulty in determining costs associated with varied or multiple tasks performed by certain employees. Making these determinations is an arduous process, and the results are rarely capable of surviving scrutiny due to the degree of judgment required under the approach.

Reconciliation of approaches. The last subsection touches on reconciliation of the results obtained under the three approaches. Here, again, preference is given to the market approach when the Job Aid notes that the reconciliation will "generally rest on the market approach (comparison to compensation for similar positions in similar companies)." The Job Aid then goes on to note that the income and cost approaches, as well as financial analysis, are then used to refine the reasonable compensation amount.

Section IV: Taxpayer Arguments for Reasonable Compensation Issues. This section sets out five common points of argument promoted by taxpayers in defending compensation adjustments, as listed below:

- Some of the compensation is for prior years' under-compensation.
- The employee performs multiple jobs.
- The "hypothetical independent investor" test was satisfied.
- The employee personally guarantees company debt.
- The employee is a key person at the company or is a superior performer who deserves extraordinary compensation.

Each of these points is sufficiently broad so as to merit consideration in most reasonable compensation challenges. One would rarely study a reasonable compensation case without observing one or more of these taxpayer arguments. Although the discussions are somewhat sparse, the information is helpful, in that it provides some indication of the primary considerations required to substantiate these common points. The Job Aid also sets the tone that one defending a reasonable compensation challenge might encounter from the IRS.

Section V: Consideration of Penalties & Section VI: Special Considerations if the Taxpayer Is a Tax-Exempt Entity. The remaining sections of the Job Aid are brief but provide important information about the two subjects. Taxpayer penalties are always important concepts with which practitioners should be concerned under the Code.

However, the subject matter contained therein does not align directly with the technical aspects of proving a reasonable compensation determination and, as such, has been excluded from discussion in the article.

Likewise, payment of unreasonable compensation to a disqualified individual in a tax-exempt entity represents an extremely specialized technical matter and, as such, is not addressed fully in this article. The determination of appropriate and reasonable compensation does, however, follow the information set forth herein.

Appendices. As previously noted, the Job Aid is accompanied by a substantial series of Appendices, which are sure to serve as a valuable resource for practitioners and taxpayers, as well as personnel within the IRS. This section includes suggested further readings on this topic; data sources for compensation issues; information document request (IDR) suggestions; examples of a financial analysis; a market approach calculation and an income approach calculation; court cases by subject matter; and, finally, an example of not-for-profit analysis.

Reasonable compensation determinations and experts. While the Job Aid notes that "reasonable compensation is, at its base, a business valuation problem where what is being valued is an employee's services and the attributes that he or she brings to a company," there is some concern on the author's part that determination of reasonable compensation is such a process that it requires specialized knowledge and not just general business valuation knowledge.

In *K & K Veterinary Supply, Inc.*,[7] a less-than-often cited 2013 case, the taxpayer's expert was a tax manager with a large regional CPA firm who had experience in litigation support, dissenting shareholder rights, marital dissolution, tax compliance, and financial advisory services. The IRS expert, on the other hand was an executive compensation expert who had qualified as an expert before Congress, as well as numerous courts, including the Tax Court.

The court found the taxpayer's expert's report to be of "dubious value" and accorded it little weight. However, it found the IRS expert more persuasive and decided the issue on his report.

The simple point of this case is that the determinations of reasonable compensation can be complex and sophisticated. The proper defense of a challenge should carefully include all avenues of defense, as well as the most time proximate data to ensure the best result.

Conclusion

As with the Job Aids relating to discounts for lack of marketability and S corporations, the Reasonable Compensation Job Aid offers little in the way of new information or cutting-edge methodologies that might be useful in resolving challenges to compensation deductions. In addition, users of this particular Job Aid must realize that developments in this topic are constant, and with the document having passed its second anniversary of issuance, the information is already dated (as illustrated in *H. W. Johnson*, discussed above.) The Job Aid notes on its cover that it is current as of the original date of issuance only.

However, though a substantial portion of the information reflects what has been known and developed over time, the Job Aid still offers a fairly comprehensive compilation of the critical matters for consideration in addressing these issues. With this understanding, the Job Aid can be useful for practitioners and taxpayers in framing the best approach to defending compensation deductions and serve as a foundation for refined determinations of reasonable compensation.

The question that remains, though, is whether the determinations of reasonable compensation under the Job Aid are useful in the realm of making compensation adjustments in business valuation. The process of developing an understanding of reasonable compensation on an historical basis is essential to the determination of future expected compensation costs. As noted earlier, this is one avenue by which the Job Aid information can be useful. Care must be taken to ensure the estimate of economic compensation is reflective of those future expected costs.

Reasonable compensation examinations can present some interesting and challenging opportunities for practitioners and taxpayers alike. Understanding the implications of the many issues and technical requirements in the statutes, regulations, and court cases can provide valuable opportunities to properly plan for larger compensation years. By ensuring that later challenges are met with forethought and proper planning, the chances of a successful defense can be optimized.

[7] TCM 2013-84.