

Mastering the Rules of S Corporation Shareholder-Employee Compensation

THURSDAY, JANUARY 3, 2019, 1:00-2:50 pm Eastern

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Reasonable Compensation Simplified™

Reasonable Compensation for Shareholder-Employees of S Corps 2018



*The Leader in Determining Reasonable
Compensation for Closely-Held Business Owners*

1. About The Presenters



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Paul is the Founder RCReports.com, cloud software that determines Reasonable Compensation for Closely-Held Business Owners. RCReports is used by CPA's, Tax Advisors, Valuators and Forensic Accountants when they need to determine a Reasonable Compensation figure for a client. Whether it's for Compliance, Normalization or Planning, RCReports has a report to fit your need.

With a degree in Small Business & Entrepreneurship from the University of Colorado, and 25 years of experience consulting on the issue of compensation as an Executive Recruiter and Small Business Advisor, Paul is recognized as an expert in the field of Reasonable Compensation for Closely-Held Businesses.

Paul has published more than three dozen articles on the topic of Reasonable Compensation, IRS enforcement and Practice Development. These articles have appeared in numerous society journals including Ohio's CPA Voice and Michigan's CPA Advocate.



Jack Salewski, CPA CGMA

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Jack is the Vice President of Education for RCReports. He is an expert on the topic of Reasonable Compensation as it applies to S Corp, and Small Closely Held Businesses. Knowing a Reasonable Compensation figure is only half the equation. Putting the Reasonable Compensation figure into context of the Business is where the Trusted Advisor adds his knowledge and wisdom to benefit the client and their business.

Jack is also the owner of Jack Salewski, CPA, a firm that is focused on tax planning, strategic operational planning and tax preparation for small and medium sized businesses.

Jack graduated from Regis University (Collage) in 1979. He immediately joined the staff of Duffy, Gordon and Hughes, CPAs. In 1982, he became part of Duffy, Griffin and Co, CPAs. In April of 1984 Jack bought out Norm Griffin and the firm became Jack Salewski, CPA. During the last 35 plus years Jack has been part of countless business going through part or all of the business life cycle.

2. Reasonable Compensation for Shareholder-Employees of S Corps

Agenda

- 1. About the presenters**
- 2. Advantage of Distribution V. Wages**
- 3. Reasonable Compensation in the courts**
- 4. IRS Guidelines & Criteria**
- 5. Profitability of an S Corp V. Distribution of an S Corp**
- 6. How to – Approaches for Determining Reasonable Compensation**
- 7. Tips from the Experts & Colleagues**
- 8. Q&A**

3. Distribution V. Wages

1. Definitions – Interchangeable Terms

- a. Reasonable Compensation = Replacement Cost
- b. Reasonable Compensation = Fair Market Value
- c. Distributions = Dividends
- d. Distributions = Loan repayment, Return of basis
- e. Shareholder-Employee (SE) = Corporate officer
- f. Shareholder-Employee (SE) = S Corp owner

2. Example 1:

- a. Scott Stone owns 100% of the stock of an S Corp (Stone Concrete).
- b. Scott works fulltime for Stone Concrete.
- c. Stone Concrete generates \$100,000 of net income before considering Scott's salary.
- d. If Scott draws a \$100,000 salary, Stone Concrete's taxable income will be reduced to zero.
- e. Scott reports \$100,000 of wage income on his 1040
- f. Scott and Stone Concrete are liable for applicable payroll taxes:
 - i. 7.65% Stone Concretes portion of SS/Medicare = \$7,650
 - ii. 7.65% Scott's portion of SS/Medicare = \$7,650
- g. State & Federal unemployment = ???
- h. Tax liability of \$15,300+

3. Example 2: Same assumptions
 - a. Scott Stone owns 100% of the stock of an S Corp (Stone Concrete).
 - b. Scott works fulltime for Stone Concrete.
 - c. Stone Concrete generates \$100,000 of net income before considering Scott's salary.
 - d. Scott withdrawals \$100,000 from Stone Concrete as distribution
 - e. Stone Concretes taxable income will be \$100,000 and will pass through to Scott on his 1120S and be reported on his 1040
 - f. No payroll tax for Stone Concrete
 - g. No self-employment tax on distributions
 - h. Tax Savings \$15,300+

4. IRS REQUIREMENT: "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." ~ [Instructions 1120S](#)

4. Reasonable Compensation in the Courts

1. DAVID E. WATSON, P.C., V. UNITED STATES OF AMERICA 2007
 - a. Mr. Watson's firm made profit distributions:
 - i. \$203,651 in 2002
 - ii. \$175,470 in 2003
 - b. Mr. Watson received salary:
 - i. \$24,000 in 2002
 - ii. \$24,000 in 2003
 - c. The IRS objection
 - i. Graduate degree in tax
 - ii. 20 years' experience
 - iii. Worked 35 - 45 hours a week.
 - d. IRS audited Mr. Watson, calculated Reasonable Compensation:
 - i. \$91,044 for 2002
 - ii. \$91,044 for 2003
 - e. Re-characterized \$67,044 of dividends and loan payments as wages for each year = \$134,000
 - f. Total tax, penalty and interest assessed to Mr. Watson was \$48,521
 - g. Mr. Watson took the IRS ruling to court.
 - i. December 2010 the US District Court for the Southern District of Iowa ruled in favor of the IRS.
 - ii. Court findings:
 - a. General accounting
 - b. Partner of his firm
 - c. Business Structure
 - iii. Mr. Watson did NO RESEARCH on his salary figure of \$24,000 and had NO DOCUMENTATION outlining how his salary was reached.
 - h. Appealed and in February of 2012 the US Court of Appeals for the Eighth Circuit upheld the District Courts Ruling.
 - i. Mr. Watson appealed to the US Supreme Court – and that appeal was denied in October 2012

2. MCALARY V. COMMISSIONER 2013

- a. McAlary LTD – Real Estate Company
- b. Mr. McAlary worked full time
- c. Zero salary
- d. \$240,00 distribution
- e. IRS calculation of Mr. McAlary's Reasonable Compensation \$100,755:
 - i. Primary job function Real estate broker
 - ii. Full time (12 hour days 6-7 days per week)
 - iii. Compared McAlary LTD to peers
 - iv. $\$48.44 \text{ per hour} \times 2080 = 100,755$
- f. Mr. McAlary defense of \$24,000 Reasonable Compensation:
 - i. Compensation agreement
 - ii. Board of Directors
 - iii. Built in increases
- g. Court calculation of Mr McAlary Reasonable Compensation \$83,200:
 - i. Various services
 - ii. BLS wage range
 - iii. $\$40 \text{ per hour} \times 2080 = 83,200$
- h. Determining an employee's reasonable compensation is dependent upon a number of factors and is far from an exact science.

3. Court Rulings:

- a. Sean McAlary Ltd, Inc. v. Commissioner 2013
- b. Glass Blocks Unlimited v. Commissioner 2013
- c. Patrick & Suzanne Herbert v. Commissioner 2012
- d. **David E. Watson, P.C. v. United States 2010**
- e. **JD & Associates, LTD v. United States 2006**
- f. **Joseph M. Grey Public Accountant, P.C. v. Commissioner 2002****
- g. **Veterinary Surgical Consultants, P.C. v. Commissioner 2001****
- h. Joly v. Commissioner 2000
- i. **Spicer Accounting, Inc. v. United States 1990**
- j. Joseph Radtke, S.C. v. United States, 1989
- k. etc.....

5. IRS guidelines for determining Reasonable Compensation for Shareholder-Employees of S Corps

1. IRS Definition of Reasonable Compensation: “Reasonable compensation is the value that would ordinarily be paid for like services by like enterprises under like circumstances”
2. Reasonable Compensation – Internal Revenue Services in section 162(a)(1): (1) the amount of compensation must be reasonable and (2) payments must be in fact for services rendered.
3. Notice of Acceptance as an S Corporation
4. Definition of a small business
 - a. Under \$10 million in Assets (IRS)
 - b. Under \$7.5 million in Revenue (SBA)
 - c. Under 250 employees (SBA)
5. [IRS Reasonable Compensation Guidelines](#)
 - a. “The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation. As such, we need to look to the source of the S corporation's gross receipts.”
 - b. The three major sources of gross revenue are:
 - i. Services of non-shareholder employees, or
 - ii. Capital and equipment
 - iii. Services of shareholder
6. [Fact Sheet 2008-25](#)
7. Factors in determining reasonable compensation:
 - 1) Training and experience
 - 2) Duties and responsibilities
 - 3) Time and effort devoted to the business
 - 4) What comparable businesses pay for similar services
 - 5) The use of a formula to determine compensation
 - 6) Payments to non-shareholder employees
 - 7) Compensation agreements
 - 8) Timing and manner of paying bonuses to key people
 - 9) Dividend history

6. Profitability V. Distribution and Reasonable Compensation

1. IRS guidelines: “The amount of reasonable compensation will never exceed the amount received by the shareholder either directly or indirectly”
~ IRS Code: Section 162-7(b)(3)

2. Example 1:
 - a. Scott Stone 100% of Stone Concrete (S Corp)
 - b. Scott’s RC figure = \$68,788
 - c. Stone Concrete Net Profit = \$210,000
 - d. Scott takes \$200,000 out of Stone Concrete
 - e. Scott receives wages (RC) of \$68,788
 - f. Scott receives a distribution of \$131,212

3. Example 2:
 - a. Scott Stone 100% of Stone Concrete (S Corp)
 - b. Scott’s RC figure = \$68,788
 - c. Stone Concrete Net Profit = \$23,000
 - d. Scott takes \$30,000 out of Stone Concrete
 - e. Scott receives wages (RC) of \$30,000
 - f. Scott receives a distribution of \$0

4. Example 3:
 - a. Scott Stone 100% of Stone Concrete (S Corp)
 - b. Scott’s RC figure = \$68,788
 - c. Stone Concrete Net Profit = \$150,000
 - d. Scott takes \$0 out of Stone Concrete
 - e. Scott receives wages (RC) of \$ 0.00
 - f. Scott receives a distribution of \$ 0.00

5. Example 4:

	2014	2015	2016	Total
Scott RC	\$70k	\$70k	\$70k	\$210k
Net Profit	\$150k	\$175K	\$200K	\$525K
Scott Takes	\$0	\$0	\$500k	
Wages	\$0	\$0	\$210	
Distribution	\$0	\$0	\$290k	

	2015	2016	2017		2015-2017
Reasonable Compensation	\$70,000	\$70,000	\$70,000		\$210,000
FICA 12.4% (2017 limit 127,200)	\$8,680	\$8,680	\$8,680		\$15,773
Medicare 2.9% (all)	\$2,030	\$2,030	\$2,030		\$6,090
Medicare Surtax 0.9% (over \$200K)	\$0	\$0	\$0		\$90
	\$10,710	\$10,710	\$10,710		\$21,953
			Total	\$32,130	
				-\$21,953	
			Tax Savings	\$10,177	

6. IRS cannot create compensation. IRS can only re-characterize what was actually paid; it cannot force a shareholder to take money out of the corporation.

7. Glass Blocks Unlimited – Fredrick Blodgett
 - a. This scenario is possible because Reasonable Compensation is not tied to Profit or Loss but to Distributions
 - b. Background on this case: Glass Blocks Unlimited – Fredrick Blodgett
 - i. 2007 Net Income = \$877
 - ii. 2007 Transferred in = \$45,000
 - iii. 2007 Transferred out = \$30,844
 - iv. 2007 Salary = Zero
 - c. IRS Position
 - i. Transfer in was a contribution to capital (basis)
 - ii. Transfer out was a distribution (Return of basis)
 - iii. Reasonable Compensation must be paid before a distribution can be made
 - d. Glass Blocks Position
 - i. Transfer in was a shareholder loan to GBU
 - ii. Transfer out was a repayment of the shareholder loan
 - iii. Reasonable Compensation does not apply
 - e. Courts have established a nonexclusive list of 13 factors they consider when evaluating whether the funds transferred into the S Corp were a loan or actually a capital contribution. Such factors include:
 1. the names given to the documents that would be evidence of the purported loans
 2. the presence or absence of a fixed maturity date
 3. the likely source of repayment
 4. the right to enforce payments
 5. participation in management as a result of the advances
 6. subordination of the purported loans to the loans of the corporation's creditors
 7. the intent of the parties
 8. the capitalization of the corporation
 9. the ability of the corporation to obtain financing from outside sources

10. thinness of capital structure in relation to debt
 11. use to which the funds were put
 12. the failure of the corporation to repay
 13. the risk involved in making the transfers
- f. Where the expectation of repayment depends solely on the success of the borrower's business, rather than on an unconditional obligation to repay, the transaction has the appearance of a capital contribution.

8. Substantial Services – The Davis Case 1994

- a. Mile High Calcium Owned by:
 - i. Carol L. Davis
 - ii. Henry Adams (husband)
 - iii. Transfers In and Out
 - iv. Assessment \$39,220
- b. Henry Adams – President (Officer)
 - i. No Active Participation
 - ii. Worked for outside employers
 - iii. There is an exception for officers who perform only minor services... (Treas. Reg. § 31.3121(d)-(1)(b))
- c. Carol L. Davis
 - i. 12 hours per week
 - ii. Services worth \$8.00 hour
 - iii. FICA & FUTA \$647.32

8. Determining Reasonable Compensation - Cost Approach

1. AKA: **Many Hats Approach** – similar to pricing out the cost of a new home. Start with a set of plans, do a take-off of what's needed. Multiply everything out and add it together = cost to build the house.
 - a. Takes into account all tasks performed
 - b. Apportion Time
 - c. Skill/Proficiency – similar to grade of finishes in a home
 - d. Comparability data – what things cost
2. Comparability Data
 - a. Cross Industry comparable wage data
 - b. Local Level
 - c. Hourly
3. Small Business Owners who wear multiple hats

Market Approach

1. AKA **Industry Comparison Approach** – Similar to valuing a house in a tract neighborhood. Neighborhoods are different but the homes in them are similar. Find other homes that have sold in the same neighbor with roughly the same size and finishes to come up with a value for your home.
 - a. Industry & Size comparable wage data
 - b. Head Honcho – Usually GM or CEO
 - c. Annual
2. Medium Businesses

Income Approach

1. AKA Independent Investors Test – similar to valuing commercial real estate. The investor may be curious what the market and/or cost approach is, but what their really interest in is the return on their investment.
 - a. No Comparable Wage Data
 - b. ROI v. Reasonable Compensation
 - c. SMB Outliers
 - i. Unique Occupation, Skill or Duties
 - ii. Superior Employee/Key Employee (Phenomenal Results)

Outliers

Outliers: If an individual is truly unique because of special skills, duties or spectacular results, whose achievements are so great that they deserve compensation above that of their peers, then his or her replacement compensation may need to be determined by means other than comparability data. Some people are simply off-the-chart.

- Unique Occupation Skill or Duties
- Spectacular Results
- Superior/Key Employee

7. Reasonable Compensation & the IRS

1. W-2 Or 1099
 - a. Revenue Ruling 74-44; IRC §states:
 - i. An officer of a corporation is considered an employee
 - b. [Employee](#) or Independent Contractor
 - i. Under common-law rules, anyone who performs services for you is your employee ***if you can control what will be done and how it will be done.***
2. Red Flags – Triggering an Audit
 - a. Zero Reasonable Compensation and Large Distribution
 - b. [Low Salary v. Distribution \(\\$24k; \\$36k\)](#)
 - c. Ratios out of line
 - i. Sales v. Compensation
 - ii. Distribution v. Compensation
 - iii. Profit v. Compensation
3. IRS Preparer Penalties \$5,000 [IRC sec. 6694](#) & [Circular 230](#)
 - a. Larry Jacobson, CPA/JD- AICPA [Tax Preparers Beware](#)
 - i. ...the IRS does expect preparers to have appropriate checklists for different types of clients. The IRS appropriately expects preparers to elicit information from taxpayers that would be reasonably necessary to prepare a tax return.
 - ii. ...the IRS does not expect the preparer to merely accept the information given to her by the client. Rather, the IRS anticipates the preparer will review the information given by the client, compare that information to a checklist or some other written procedure and ask the client for additional

information if necessary for the preparer to complete a professional tax return.

- iii. ...the IRS does require the preparer to be proactive in terms of asking for the right information necessary to prepare tax returns, even if it means the preparer will need to spend more time with the client during the preparation process.
 - iv. ...penalties can and will be imposed on preparers who fail to make reasonable inquiries of their clients during the preparation process.
- b. Pay Penalties & Interest
 - c. Amend Returns no charge
 - d. Malpractice Claim
 - i. 2 or more shareholders
 - ii. Retirement Plans

8. Determining Reasonable Compensation

1. IRS [Job Aid \(Appendix\)](#)
 - a. Developed by a Team of IRS Valuation Professionals From the Large Business and International Division
 - b. This Job Aid is not an official pronouncement of law, and cannot be used, cited, or relied upon as such
 - c. Companies have the burden of showing that compensation is reasonable
 - d. Good Resource for Audit
 - e. [Companion book by Michael A. Gregory](#)

9. Tips from Experts & Colleagues

1. [Reasonable Compensation compliance for all of your S Corps](#)
 - a. Year 1- Group A
 - i. New Clients
 - ii. Issue Letter
 - b. Year 2- Group B
 - i. Reminder
 - ii. Requirement
 - c. Year 3- Group C
 - i. Final Warning
 - ii. Cut 'em loose
2. Reasonable Compensation - Sensitive Issue
 - a. Reasonable Compensation is defined by valuation professionals as the hypothetical replacement cost of an owner or key manager of a business.
3. Tips From the Experts
 - a. Overlooked on Tax Returns: Stephen D. Kirkland
 - i. Occupation next to signature – Form 1040
 - ii. Percent of time devoted to business – Form 1125-E
 - iii. Business activity code – NAICS/SIC
 - iv. *An opinion has value if it is supported and can be defended.*
 - b. Corporate Minutes: Dennis Tafelski - Internal Revenue Agent - Retired
 - i. One of the first things an examiner does during an audit is ask to see the corporate minute book.
 - ii. If the examiner sees that the taxpayer took the time to best determine what shareholders should be paid.
 - iii. Indicate this in their lead sheet of audit issues and not continue to pursue this issue.
 - c. Reasonable Compensation: Application and Analysis for Appraisal, Tax and Management Purposes: Ron Seigneur & Kevin Yeanoplos

Conclusion

1. Number one problematic area per GAO & TIGTA:
 - a. Compensation Paid To Shareholders Who Perform Services
 - b. Underpayment of salaries results in the large underpayment of FICA taxes
2. The IRS & courts have made it clear that distributions to a shareholder who performs services to their S Corp will be re-characterized as wages if the distributions are actually disguised compensation.
3. Who should research and document their Reasonable Compensation figure
 - a. Any Shareholder-Employee of an S Corp who performs services for their company.
4. No Safe Harbor
 - a. An accounting method that avoids legal or tax regulations and allows for a simpler method (usually) of determining a tax consequence than those methods described by the precise language of the tax code.
5. Reasonable Compensation is Subjective
 - a. “Determining an employee's reasonable compensation is dependent upon a number of factors and is far from an exact science.”
6. How to support your Reasonable Compensation Figure:
 - a. Develop a consistent year to year Reasonable Compensation policy
 - b. Determine your Reasonable Compensation figure using the IRS guidelines and the 9 factors handed down by the courts
 - c. Add your Reasonable Compensation documentation, reasoning, and notes to your corporate minutes

7. Best Practice: Compensation must be both Reasonable & Supportable with a clear documentation outlining how the compensation figure was reached

8. Steps to reach a replacement cost or FMV figure
 - a. Make a complete list of all the services you provide to your S Corp
 - b. Apportion your time among all the services listed
 - c. Rate your level of expertise and experience for each service performed
 - d. Gather wage data on all the services listed and at the appropriate level of expertise
 - e. Assemble all your research and data and calculate your Reasonable Compensation figure

Notes

Appendix A

Reasonable Compensation Case Study

Reasonable Compensation Case Study

Scott Stone ~ Stone Concrete

Following is a Reasonable Compensation case study for Scott Stone. This case study follows Scott through his career and determines Reasonable Compensation for Scott at three different points in his career using the three different approaches recognized by the IRS.

Scott is the owner of Stone Concrete. His business specializes in concrete patios, sidewalks, driveways etc...



Scenario One:

Meet Scott Stone at age 30. Scott owns Stone Concrete, an S Corp with seven full-time employees including Scott and annual gross income of \$250,000.

Because Scott's business would be considered a small business, we will be determining Scott's Reasonable Compensation using the **Cost Approach** (AKA the multiple hats approach). This approach tends to work best with small businesses where the owner performs multiple duties (wears multiple hats).

We have gathered the following information on Scott and his business:

How many hours do you work per week on average? 40+				
State your business is located Illinois				
County or township your business is located Cook				
Yes/No	Title	Definition	Time %	Proficiency
X	Sales Representatives	Sell goods or services for wholesalers or manufacturers to businesses or groups of individuals. Work requires substantial knowledge of items sold.	10%	Below Average
X	Bookkeeper	Compute, classify, and record numerical data to keep financial records complete. Perform any combination of routine calculating, posting, and verifying duties to obtain primary financial data for use in maintaining accounting records. May also check the accuracy of figures, calculations, and postings pertaining to business transactions recorded by other workers.	10%	Below Average
X	Purchasing Clerk	Compile information and records to draw up purchase orders for procurement of materials and services.	5%	Average
X	Business Office Manager	Plan, direct, or coordinate one or more administrative services of an organization, such as records and information management, mail distribution, facilities planning and maintenance, custodial operations, and other office support services.	15%	Average
Please list any specialized tasks which fall outside the common tasks that you've already selected from. You may add as many specialized tasks as you need to adequately account for all the other tasks you perform for your business regularly throughout the year and then rate your skill level for each task added. (Example: Veterinarian; Hair Stylist; Pastry Chef; Etc...)				
Title	Description	Time %	Proficiency	
Concrete Finisher	Smooth and finish surfaces of poured concrete, such as floors, walks, sidewalks, roads, or curbs using a variety of hand and power tools. Align forms for sidewalks, curbs, or gutters; patch voids; and use saws to cut expansion joints.	30%	Above Average	
Maintenance Mechanic	Perform work involving the skills of two or more maintenance or craft occupations to keep machines, mechanical equipment, or the structure of an establishment in repair. Duties may involve pipe fitting; boiler making; insulating; welding; machining; carpentry; repairing electrical or mechanical equipment; installing, aligning, and balancing new equipment; and repairing buildings, floors, or stairs.	30%	Above Average	
		100%	TOTAL	

After inputting the above data into RCReports the following report is produced:

(Following are pages 1-2 of what is typically a 5-7 page report that would include additional information on methodology, court cases, IRS info and sample corporate minutes)



POTOMAC

Tax & Valuation

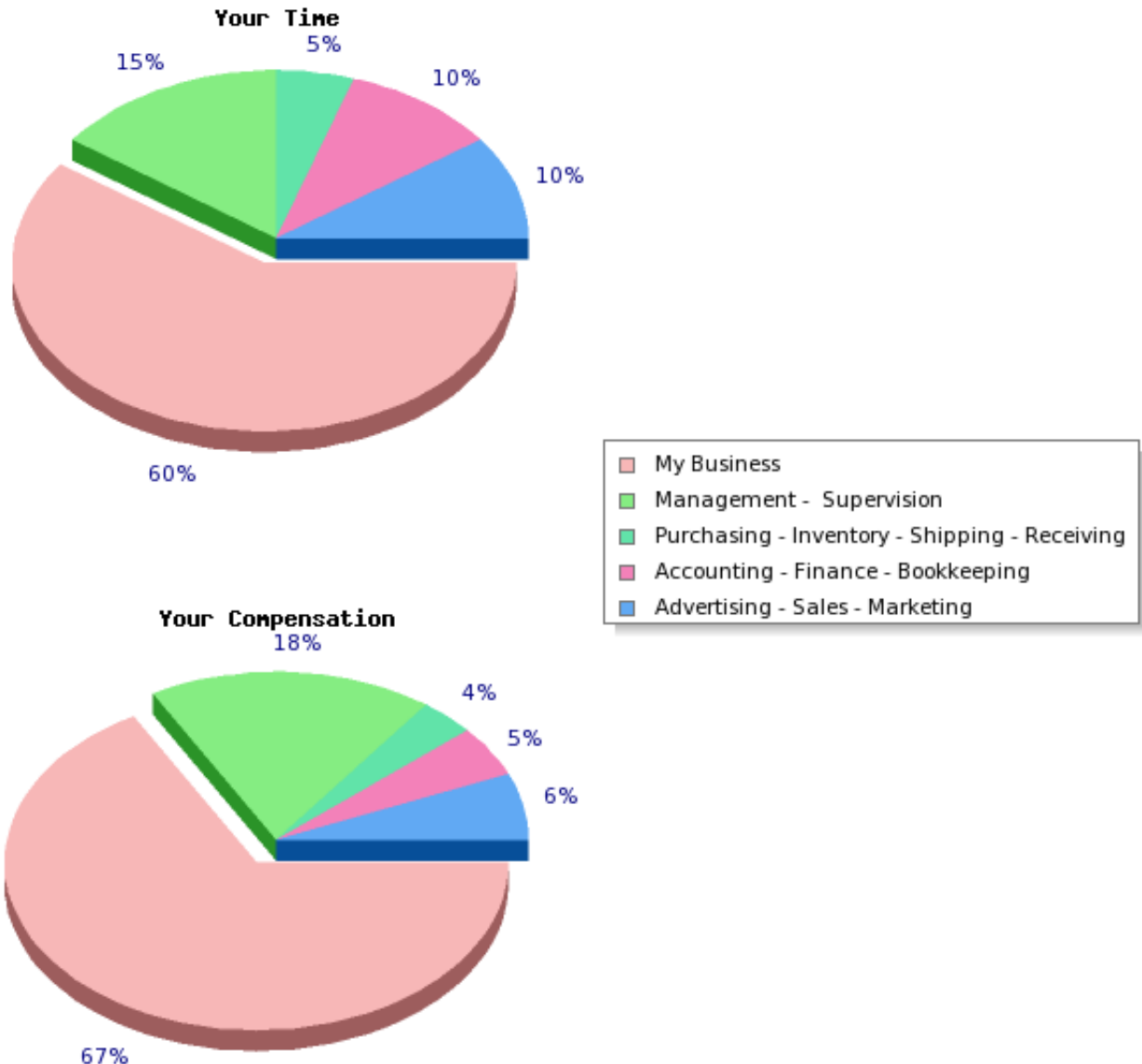
2018 Report for Scott Stone of Stone Concrete, Inc.

Your estimated annual Reasonable Compensation: \$68,788

Thank you for entrusting Sam Miller of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your S Corporation based on your responsibilities and the duties that you perform annually. Reasonable Compensation is defined by the IRS as "The value that would ordinarily be paid for like services by like enterprises under like circumstances".

The calculated salary of **\$68,788** was determined to be reasonable compensation based on the type of work performed, the skill level of the work performed and the number of hours the work is performed annually. You told us that you work **2080** hours per year in **Cook County, IL**. Our analysis indicates the annual salary of \$68,788 would be a reasonable cost to hire employee(s) to perform the duties and responsibilities that you currently perform.

Potomac Tax and Valuation, PC recommends completing a reasonable compensation report annually.



Annual Salary and Reasonable Compensation are used interchangeably in this report. All salary and reasonable compensation figures are expressed annually and in U.S. dollars.



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2018 Report for Scott Stone of Stone Concrete, Inc.

Advertising - Sales - Marketing

10% of
your time

208 hours
per year

6.4% of
your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Sales Representatives	Below Avg.	100%	10%	208.0	\$ 21.18	\$ 4,405

Accounting - Finance - Bookkeeping

10% of
your time

208 hours
per year

4.89% of
your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Bookkeeper	Below Avg.	100%	10%	208.0	\$ 16.16	\$ 3,361

Purchasing - Inventory - Shipping - Receiving

5% of
your time

104 hours
per year

3.57% of
your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Purchasing Clerk	Average	100%	5%	104.0	\$ 23.61	\$ 2,455

Management - Supervision

15% of
your time

312 hours
per year

18.29% of
your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Business Office Manager	Average	100%	15%	312.0	\$ 40.33	\$ 12,583

My Business

60% of
your time

1,248 hours
per year

66.85% of
your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Concrete Finisher	Above Avg.	50%	30%	624.0	\$ 45.21	\$ 28,211
Maintenance Mechanic	Above Avg.	50%	30%	624.0	\$ 28.48	\$ 17,772

*Annual Salary and Reasonable Compensation are used interchangeably in this report.
All salary and reasonable compensation figures are expressed annually and in U.S. dollars.*

Scenario Two:

Meet Scott Stone at age 45. Stone Concrete has grown significantly, is still an S Corp and has grown to 35 employees and 7 million in annual gross revenue. Scott's primary job function for Stone Concrete is now CEO.

Because Scott's business would be considered a medium business, we will be to determining Scott's Reasonable Compensation using the **Market Approach** (AKA the industry comparison approach). This approach tends to work best when the company is larger, more mature and the business owner is acting in a management capacity.

We have gathered the following information on Scott and his business:

In order to help us build your Reasonable Compensation profile, tell us a little more about yourself and your business:	
Industry	Specialty trade contractors
Occupation	CEO
State	Illinois
Metro area	Chicago
Number of employees	35
Gross revenue	7 million
Business performance versus peers	Above average
Owner experience versus peers	High
Hours worked per week on average	55

After inputting the above data into RCReports the following report is produced:

(Following is the first page of what is typically a five page report that would include additional information on methodology, court cases, IRS info and sample corporate minutes)



POTOMAC

Tax & Valuation

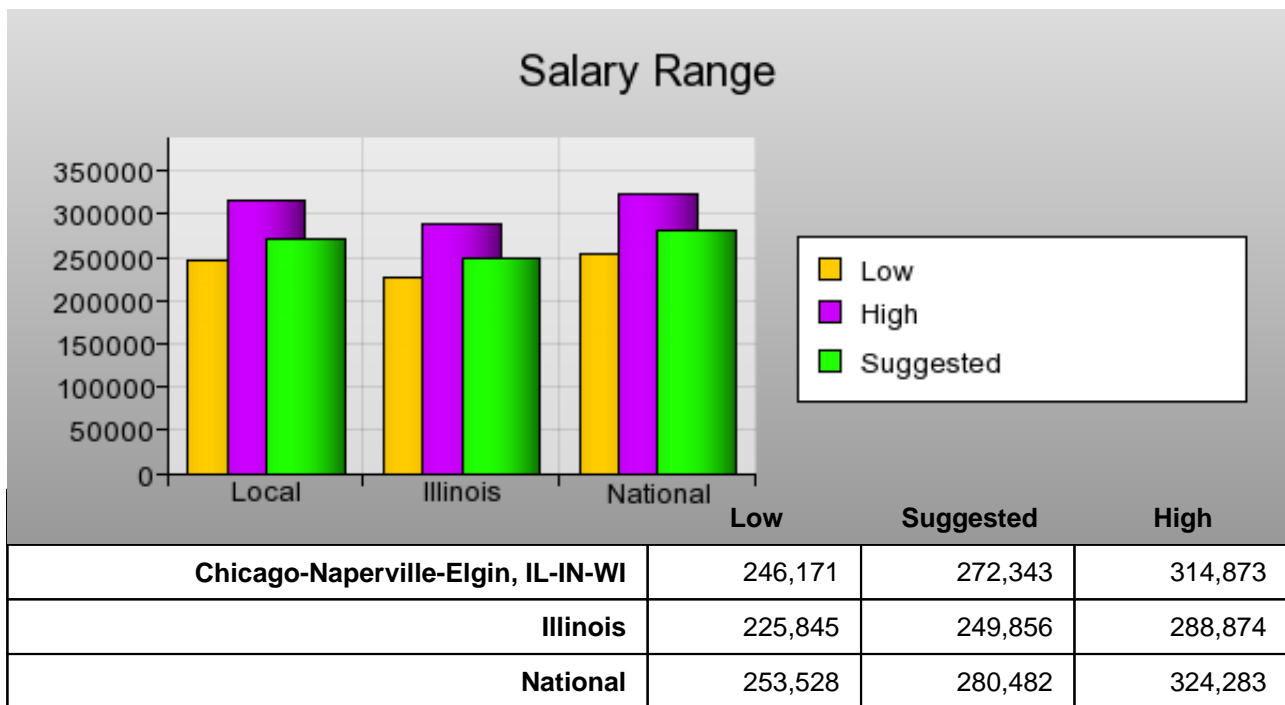
Report for Scott Stone of Stone Concrete, Inc.

Your estimated annual Reasonable Compensation: \$272,343

Thank you for entrusting Sam Miller of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your S Corporation based on your responsibilities and the duties that you perform annually. Reasonable Compensation is defined by the IRS as "The value that would ordinarily be paid for like services by like enterprises under like circumstances".

Your suggested salary range: \$225,845 to \$314,873 with a suggested salary of \$272,343 was determined to be Reasonable Compensation based on your role in the company, industry, size of the business, time devoted to the business, your experience and location. Any wage selected within the suggested range or expanded geographical area(s) is acceptable and within a 95% confidence interval.

Potomac Tax and Valuation, PC recommends completing a Reasonable Compensation report annually.



Scenario Three:

Meet Scott at age 55. Ten years earlier Scott started a new company called Stone Technologies, a C Corp. Scott has developed multiple new technologies for the concrete industry and has patented them.

Scott is the only employee of Stone Technologies, and Scott would best be classified as an inventor. His business revenue is growing at an exponential rate, and we are having a very difficult time finding comparable wage data for Scott. Because of this we are going to be determining Scott's Reasonable Compensation using the **Income Approach** (AKA the independent investors test).

This approach does not rely on comparable wage data, but instead relies on a simple algorithm used by the IRS. This approach tends to work best for what we term outliers, these are business owners who have a unique occupation or who are achieving results significantly better than their peers. Therefore comparability data is not available or appropriate to use.

We have gathered the following information on Scott's business:

In order to help us build your Reasonable Compensation profile, tell us a little more about yourself and your business:	
Estimated FMV beginning of the year	6,000,000
Estimated increase in FMV by year end	1,750,000.00
Target return (independent investor rate)	20%

After inputting the above data into RCReports the following report is produced (included 1 of 5 pages):

(Following is the first page of what is typically a five page report that would include additional information on methodology, court cases, IRS info and sample corporate minutes):



POTOMAC

Tax & Valuation

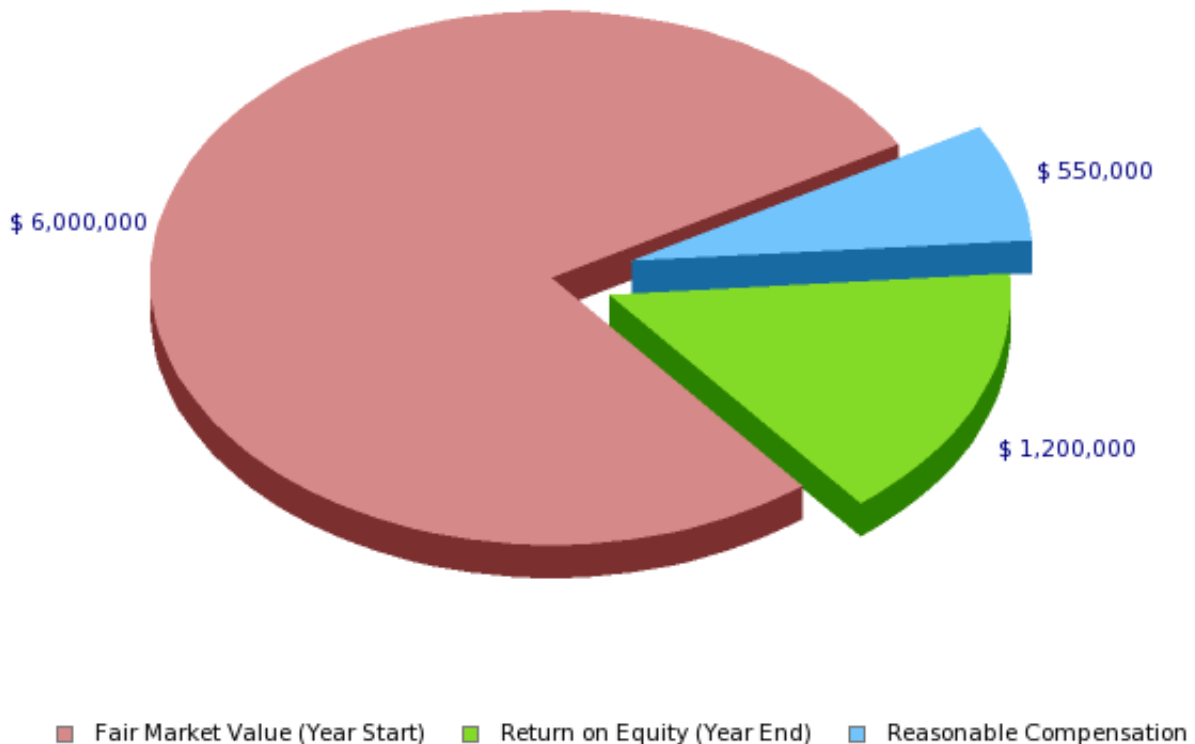
Report for Scott Stone of Stone Technologies, Inc.

Your estimated annual Reasonable Compensation: \$550,000

Thank you for entrusting Sam Miller of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your C Corporation based on your responsibilities and the duties that you perform annually. Reasonable Compensation is defined by the IRS as "The value that would ordinarily be paid for like services by like enterprises under like circumstances."

The calculated salary of \$550,000 was determined to be Reasonable Compensation based on the increase in the Fair Market Value of your company over a one year time frame and a Return on Investment of 20.00% in conjunction with your efforts.

Potomac Tax and Valuation, PC recommends completing a Reasonable Compensation report annually.



*Annual Salary and Reasonable Compensation are used interchangeably in this report.
All salary and reasonable compensation figures are expressed annually and in U.S. dollars.*

Appendix B

Reasonable Compensation Stress Test

Preparer Penalty Check List and Stress Test

The best way to prevent preparer penalties and protect your client from a Reasonable Compensation challenge is to use a check list to make sure you have adequately covered Reasonable Compensation with your S Corp clients and stress tested their Reasonable Compensation figure against some of the factors the courts use.

CLIENT	NAME:	Yes	No
1	Send Issue Letter to Client (Educate your Client)		
2	Did you run a Reasonable Compensation Report on the Client?		
	OR		
	Did the client provide Independent Research and Documentation to support their Reasonable Compensation Figure?		
3	Does the clients Reasonable Compensation figure, on its face, appear to be reasonable based on the Clients:		
3a	Training and Experience		
3b	Duties and Responsibilities		
3c	Time and Effort Devoted to the Business		
3d	Location of the Business		
4	Did the Client make as much or more than any non-shareholder-employees of the business, for performing essentially the same services? (Internal Consistency)		
5	Did the Client pay themselves via W-2 (It's the Law)		

If you answered YES to all questions above you are in good shape. You have made a reasonable attempt to comply with IRS guidelines and court rulings and this check list creates a defensible position for you and your client should the IRS raise the issue.

Save a copy of this check list with your clients file.

Appendix C

Reasonable Compensation Issue Letters

Year 1 ~ Letter 1

Mr. Tom Jones
111 First Street
Anytown, CO 88888

Dear Tom,

As your tax advisor, I need to alert you to your responsibility to accurately determine and document your Reasonable Compensation for the services you provide to your business. Reasonable Compensation is the salary or wage that you, a shareholder-employee of an S Corp, pay yourself for the work you perform for your company.

The IRS requires that all shareholders of S Corps who perform services for their company pay themselves Reasonable Compensation, and it needs to be paid prior to taking any distributions. There are two ways to think about Reasonable Compensation:

1. Replacement Cost: What would it cost your company to pay another person(s) to provide all the services you currently provide?
2. Fair Market Value: What would other businesses in your community pay you for the services you currently provide to your company?

The IRS has updated its [guidelines](#). It is more important than ever that you **research and document** how you determined your Reasonable Compensation figure.

We have tools available to make it easy for you to accurately determine your Reasonable Compensation figure. Please contact me if you would like to discuss this issue further or to have me complete a Reasonable Compensation Report for you.

A Reasonable Compensation Report is an independent unbiased report that establishes your Reasonable Compensation using criteria outlined by the IRS and Courts and provides a defensible position to an IRS challenge.

The best time to establish your Reasonable Compensation figure is now, before an IRS examination. Reasonable Compensation has become an IRS hot button and we have been told to expect an increase in examinations of S Corps:

- S Corp audits up 14% in 2015
- June 2016: IRS announces it is focusing more resources on S-Corps.

A Reasonable Compensation challenge can be costly. Typically, taxes, penalty, and interest are more than double the original tax that would have been owed – plus costs for amending returns.

Please call me at your convenience so you can take the necessary steps to protect yourself on this issue.

Sincerely,

(CPA name)
(CPA Firm)

Year 2 ~ Letter 2

Mr. Tom Jones
111 First Street
Anytown, CO 88888

Dear Tom,

Last year I alerted you to your responsibility to accurately determine and document your Reasonable Compensation for the services you provide to your S Corp. (attached)

I wanted to make you aware that this year, our firm is now **requiring** *Independent* research and documentation to support Reasonable Compensation for all our S Corp clients. This area of compliance has increasingly become a hot spot with the IRS. Beginning in 2005 the IRS began studying the issue and since 2005 has changed their enforcement and compliance strategy and updated their [guidelines](#). Through a series of court cases and IRS notices, we have seen this issue become increasingly pursued by the IRS and local taxing authorities over the last few years.

This means that it is now more important than ever that you have **research and documentation** to support your Reasonable Compensation figure.

We have tools available that will provide the Independent research and documentation we require. I urge you to have our firm complete a Reasonable Compensation Report for you.

A Reasonable Compensation Report is a detailed report that establishes your Reasonable Compensation using criteria outlined by the IRS and Courts and provides a defensible position to an IRS challenge.

We do not require you to have a Reasonable Compensation Report completed by our firm. However, if you don't have us complete a report for you, you will need to provide us with sufficient documentation to support your Reasonable Compensation figure.

A Reasonable Compensation challenge can be costly. Typically, taxes, penalty, and interest are more than **double** the original tax that would have been owed – plus costs for amending returns.

Please call me at your convenience so you can take the necessary steps to protect yourself on this issue.

Sincerely,

(CPA name)
(CPA Firm)

Year 3 ~ Letter 3

Mr. Tom Jones
111 First Street
Anytown, CO 88888

Dear Tom,

For the last two years I have alerted you to your responsibility to accurately determine and document your Reasonable Compensation for the services you provide to your S Corp. (attached)

Last year, I notified you that our firm now **requires** *Independent* research and documentation to support Reasonable Compensation for all our S Corp clients. Unfortunately we did not receive the required documentation from you last year.

I will no longer be able to complete your tax returns in the future without the required documentation. Not only has the risk increased for you, the tax payer, but the IRS is now holding Tax Preparers responsible. The IRS has made it their policy to assess preparer penalties (\$5,000 minimum) on the preparer, when a Reasonable Compensation figure has been deemed Unreasonable.

We have tools available that will provide the Independent research and documentation we require. I urge you to have our firm complete a Reasonable Compensation Report for you.

A Reasonable Compensation Report is a detailed report that establishes your Reasonable Compensation using criteria outlined by the IRS and Courts and provides a defensible position to an IRS challenge.

We do not require you to have a Reasonable Compensation Report completed by our firm. However, if you don't have us complete a report for you, you will need to provide us with sufficient documentation to support your Reasonable Compensation figure.

This area of compliance has increasingly become a hot spot with the IRS. Beginning in 2005 the IRS began studying the issue and since 2005 has changed their enforcement and compliance strategy and updated their [guidelines](#). Through a series of court cases and IRS notices, we have seen this issue become increasingly pursued by the IRS and local taxing authorities over the last few years.

A Reasonable Compensation challenge can be costly for both of us and our firm can no longer accept the risk. Typically, taxes, penalty, and interest are more than **double** the original tax that would have been owed – plus costs for amending returns.

Please call me at your convenience so you can take the necessary steps to protect yourself on this issue. I hope to remain your tax preparer for the upcoming year. However, I understand if you prefer not to meet our new requirements, in which case I wish you luck in finding the right tax preparer to meet your needs.

Sincerely,

(CPA name)
(CPA Firm)