The Business Library — **Resource Report #7**

Criteria for Setting Your Compensation

For Owners, Executives, and Family Employees Of Closely Held Businesses

- **High Cost of Excessive Compensation**
- **12 Guidelines for Setting Salaries**
- **How to Avoid Compensation Challenges**
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- **What the IRS Means by "Family"**
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16 Fox Lane, Locust Valley, NY 11560 ● 516-671-8050 (Fax: 516-671-8077)
E-mail: businesslibrary@optonline.net ● Website: www.yourbusinesslibrary.com

How Much Compensation Is Reasonable?

You want the most salary and bonuses the company can afford to pay you with the least personal and business tax liabilities. That's not an easy task.

Set the salary too high and you're asking for trouble from the IRS, other owners, and even company executives who want comparable compensation. Even a salary that is unreasonably low — perhaps you're trying to stay in a lower income tax bracket — may be questioned by the IRS.

The key is that the money you take out of the company must be *reasonable* and *justifiable.* The IRS' concern is not only with the *amount* of compensation but with the *form*, i.e., salary, dividend, or loan, in which you're taking money out of the company. That's because the form determines your tax liability as well as the company's, e.g., dividends are taxed to you at the capital gain rate of 15% but are not tax deductible by the company as salary payments are.

There are obvious tax advantages to moving money between you and your company. Let's say you're in an overall personal tax bracket of 25% (income up to about $128,000) and the company's combined federal and state tax rate is 38%. Take $50,000 more salary (tax deductible by the company) and you and the company together **save** 13 percentage points in taxes or $6,500.

The overriding question for the IRS is whether your salary decisions are based on your responsibilities in the company or motivated by a desire to avoid or reduce legitimate taxes. Keep in mind that your salary should be structured as payment for services performed as an *executive* of the company, not as a return on your equity investment as an *owner.*

If the total compensation paid to an officer-owner in the form of salary, bonuses, and benefits is found to be *excessive* and *unreasonable,* the amount considered "overpayment" can be reclassified as a dividend, which means it is not tax deductible by the company and it is taxable as income to the officer-owner.

The cost of reclassification is very high. To illustrate, consider the following impact of having $50,000 of salary labeled unreasonable and reclassified as a nondeductible dividend by the IRS or the courts.

#1 — The company *cannot deduct* the $50,000 of compensation considered excessive. *Result:* In a 34% corporate tax bracket, the lost salary deduction means *$17,000 in additional taxes* (34% times $50,000).

#2 — The $50,000 becomes a dividend, which is taxable at 15%. *Even worse:* Other company owners may demand that similar dividends be paid on their stock holdings or they may sue you for withdrawing too much money from the company.

#3 — Since the IRS shares information with other regulatory bodies, you will have to *amend* your state and local tax returns and pay those agencies appropriate additional taxes.

#4 — You also may be liable for both interest and penalties on the unpaid federal, state, and local taxes on the reclassified salary.

The overall result: Each $50,000 of salary reclassification could easily cost your company over $30,000 in additional taxes, interest, and penalties, in addition to any dividends you may have to pay to the other owners (#2 above). There's also the anxiety, time, and hassle of defending yourself with the IRS.

Remember also, as the principal owner of the business, you have conflicting roles as an owner, chief executive, and board member. As a board member, it is also your fiduciary responsibility to protect the interest of all owners even if that ownership represents only 1% of the company. That means protecting those owners from unreasonably high salaries and benefits paid to you and other executives.

Note: The discussion on *unreasonable* compensation principally applies to the owners of C or regular corporations. S corporations, limited liability companies, partnerships, and sole proprietorships generally don't have to be as concerned with unreasonable compensation since all of the company's profits are passed through to their owners and taxed to them as personal income at tax rates up to 35%.

12 Guidelines for Setting Salaries

The IRS and courts consider the following factors in determining whether or not compensation is in fact reasonable and justified, so they are *good guidelines* to use in setting your own and other executive salaries. Strong back-up memoranda should be recorded in the company's minutes to show the board of director's consideration of these factors when setting officer/owner compensation.

- Comparable salaries paid to other executives in the same industry as your company. *Problem:* Your salary is three times the industry average. *Note:* To determine a comparable salary, you might want to start with business associations, which often do surveys of member salaries and benefits.

- Salaries paid to non-owner executives. *Problem:* Their salaries are only one-third of yours.

- Scope of responsibilities. *Problem:* You receive an excellent annual salary but someone else runs the company.

- Other benefits paid to the owner, e.g., cash and stock bonuses and deferred compensation plans which set aside money today to be paid to you after retirement. *Problem:* None of these big-dollar benefits are paid to other executives.

- Job qualifications, experience, and duties. *Problem:* You're really an investor/owner of the company who is inactive in the business. You receive a very high tax-deductible salary, but no dividend on your investment.

- Time devoted to the business. *Problem:* You receive a full-time salary but only work 60% of a normal work week.

- Relative size and complexity of the business. *Note:* The bigger and more complex the business, the more salary you can justify.

- Past compensation and the percentage increase each year. *Problem:* Last year, your salary was $80,000. To avoid paying business taxes this year, you paid yourself $200,000 in salary, but no dividends. On the other hand, you might be able to justify this type of increase if your company is now making big profits and you're making up for all the years of very low salary during the company's start-up period.

- Current economic conditions. *Problem:* Your annual compensation is not consistent with the company's financial performance. Good times support a higher salary; bad times, the opposite.

- Company's performance within its industry and market. *Example:* If the company's growth rate and profitability are much higher than the industry average, that supports a much higher salary.

- Loans from the company. *Problem:* You borrow from the company to avoid paying income taxes on additional salary or bonuses.

- Salary and benefits paid to spouse and other family members. *Problem:* If the amounts paid are not at arm's-length or reasonable compared to other employees doing the same type of work in the company, the excess of your family's salaries may be considered part of your personal compensation.

More IRS Red Flags

Annual return on invested capital: If the annual return on the company's stockholder's equity account is very low, say 5%, you could have difficulty justifying an above-average compensation level. In contrast, a high return on equity, say 30%, could be used to justify a higher salary. However, it also suggests that some dividends should be paid.

Capacity to pay dividends: If the company has never paid dividends but has the **capacity** (ability) to do so (i.e., because of high profits), this will support an IRS contention on unreasonable compensation. In addition, if dividends were *never* paid by the company and your salary is very high, the IRS and minority owners could question why you received the money as salary rather than dividends.

How to Avoid IRS Compensation Challenges

To help avoid unreasonable compensation challenges by the IRS and others, do the following:

(a) abstain from voting on your annual compensation and benefits;

(b) pay some dividends (taxed at only 15%) if your salary is very high;

(c) deal with the company and all affiliated businesses on an arm's-length basis;

(d) pay family members at justifiable salary levels;

(e) stay in the range of comparable salaries in your industry;

(f) keep back-up data on how you arrived at your salary and bonuses;

(g) don't borrow heavily from the company, repay any personal loans, include interest, and sign a promissory note;

(h) record all board and stockholder meeting decisions on compensation in your corporate minutes;

(i) be reasonable; don't eliminate all business profits by paying year-end bonuses to officers/owners; and, finally,

(j) comply with the IRS' discrimination rules, which requires owners and companies to treat all employees fairly on such company benefits as qualified retirement plans and health, insurance, and disability plans.

Last, analyze your *total* compensation package, including salary, benefits, perks, and loans from the company. That's how the IRS, courts, and minority owners will determine reasonableness.

More to Know

Multiple ownership: If several owners are active in the business, do not pay salaries, and particularly bonuses, in direct proportion to their ownership percentages, e.g., Johnson owns 30% of the company and gets 30% of the bonus. Salaries and bonus payments, both tax deductible, should be based on *each* executive's overall responsibilities, individual performance, and contribution to company profits, not on his or her percentage ownership position in the company.

Company loans: Again, be careful of excessive borrowing from the company. Any unreasonable amount, even when structured as a loan with a signed promissory note, interest rate, repayment schedule, etc., may be considered and labeled compensation, which would make it taxable income to you and subject to income taxes and penalties.

Affiliated companies: If you receive compensation from affiliated companies, the IRS and minority owners may include that compensation when calculating the reasonableness of your *total* compensation.

Arm's-length transactions: Deal with yourself, executives, and family members on an arm's-length basis, i.e., as an objective outsider. For the IRS' definitions of arm's-length, family members, related parties, and fair market value, please see *Exhibit 1,* page 9.

Audit tip-off: The IRS and the courts have been more generous in recent years. Salaries of $400,000 and more at profitable, smaller closely-held companies often go unchallenged by the IRS. On the other hand, if you structure your salary so remaining profits are small, your chances of an IRS audit will increase significantly. For example, before your salary, the company has profits of $400,000. Your salary lowers the profit to $50,000. Do that year after year and you're asking for trouble.

* * *

Don't get us wrong. We don't want to imply that you can *never* pay yourself an impressive salary and we don't want to discourage you from doing so just to avoid attention from the IRS. In fact, you may be completely justified in paying yourself a *very* high salary, especially if (a) your business is racking up profits ahead of its competitors, (b) you are working 60-hour weeks and wearing many hats, and (c) you passed through some very lean financial years personally in building the company up to its current size and profitability. Just be sure to document the reasons for the high salary, get your board of director's approval of all salary decisions, and record the decisions and substantiation in the board minutes.

References: Please see the next page.

References

For more information on compensation, please see the Internal Revenue Code: Section 162. For other subjects, see IRC Section 316 (Dividends Defined, Corporate Distributions), 318 (Constructive Ownership), 385 (Bona Fide Debt), and 7872 (Treatment of Loans with Below Market Interest Rates).

Exhibit 1: How the IRS Defines Family, Arm's-Length and Related Parties, page 9

Exhibit 2: Steering Clear of Trouble, page 10

Exhibit 3: Compensation Alerts to Use Today, page 11

Do not pay salaries or bonuses in direct proportion to officers' percentage of ownership in the business. That looks too much like a nondeductible dividend.

Exhibit 1

How the IRS Defines Family, Arm's-Length and Related Parties

The IRS defines *family* as the owner's spouse, parents and grandparents, children and grandchildren, siblings — all lineal descendants and ancestors. *Related parties* is defined as the company, other owners, affiliated businesses, and family members.

In IRS Revenue Ruling 59-60, the IRS defines *fair market value* as:

> "The amount (price or value) at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy, and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

In Internal Revenue Code Section 482, *arm's-length* is defined as:

> "In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's-length with an uncontrolled taxpayer. A controlled transaction meets the *arm's-length* standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's-length result)."

The safest bet: Effect all transactions at fair market value and on an arm's-length basis, particularly when dealing with related parties or affiliated companies owned by you, the company, or other related parties. ☐

Exhibit 2

Steering Clear of Trouble

- Abstain from voting on your compensation.
- Stay in the range of comparable industry salaries.
- Keep back-up data on how you arrived at your salary and bonuses.
- Deal with your company and all affiliated businesses on an arm's-length basis.
- Pay family members justifiable salaries.
- Don't borrow heavily from the company, repay all loans, include interest, and sign a promissory note.
- Don't pay salaries or bonuses in direct proportion to the officers'/owners' percentage of ownership in the business.
- Pay some dividends.
- Record compensation discussions and decisions in corporate minutes.
- Comply with the IRS' discrimination rules.
- Be reasonable; don't eliminate *all* business profits by paying year-end bonuses to officers/owners.
- Analyze your *total* compensation package, including salary, benefits, and perks. ☐

Exhibit 3

Compensation Alerts to Use Today

You want to collect as much in salary, bonus money, and benefits as you can, but without running into IRS problems and incurring unnecessary tax liabilities.

Here are more ideas to help you establish and protect your compensation; discuss with your accountant the ones that apply to you.

Salary continuation. Continue your salary during illness by effecting a salary-continuation plan. However, be aware that when salary-continuation payments have been made to a disabled stockholder *without* a written plan in effect, the courts have ruled that the payments to the stockholder were actually dividends. Nonformalized and after-the-fact plans have been disallowed by the IRS.

Recommendation: Prepare a written plan and record its approval in the company's minutes. The salary-continuation plan can be discriminatory, i.e., just for yourself, other key executives, or all employees.

Travel and entertainment. If travel and entertainment expenses (T&E) are *not* fully documented or justified by company owners, the IRS may label the T&E reimbursement as a dividend, which is not tax deductible by the corporation. In fact, under the IRS rules, any owner of more than 10% of the company is required to itemize *all* travel and entertainment expenses. Don't forget that a written statement is required on the company's tax return indicating that proper auto-travel records have been kept.

Family members: This documentation requirement also applies to expenses reimbursed to family members of the owner who work for the business.

Compensation and form of business. If you are starting a new business or the company earns less than $100,000, you should consider operating as a regular or C corporation, rather than as a partnership, S corporation, or limited liability company since the profits from these business entities are passed through to their owners.

Reason: The C corporate tax rate is only 15% on the first $50,000 of taxable income, 25% on the next $25,000, and then 34% on the next $25,000. Thus, the overall effective corporate tax rate on the first $100,000 is only 22.25%, versus higher personal income tax rates of 25%, 28%, 33%, and 35%.

A regular C corporation may *not* be a good idea, however, if the company earns more than $100,000; the C corporate tax rate is 39% for taxable income between $100,000 and $335,000, and then 35% thereafter.

When personal and corporate tax rates are basically the same, the S corporate, limited liability, and partnership forms usually are better choices because they allow you to take the income without the IRS raising unreasonable compensation questions or reclassifying the excess salary payments as dividends.

Deferred compensation. Consider setting up a deferred compensation plan to postpone receipt of a portion of your salary or bonuses to later years after you retire. The deferred salary is not taxable income until paid to you. However, if you and the company have the same tax rates, take the money now because the deferral won't deliver enough tax advantages to offset the wait for the money.

Company loans. On all borrowings from the company, make sure written documents show the loan is indeed a loan and not compensation or a dividend, both of which would be taxable income as the loan is repaid.

How to avoid taxation: Record the loan on the company's books; execute a promissory note; pay interest; provide collateral if available; and repay the loan in a reasonable period of time. In essence, effect an arm's-length transaction, i.e., as if another employee or third party was borrowing the money.

Set up Keogh Plan to shelter compensation. If you are self-employed or have a second source of income, e.g., as a paid board member or consultant, you may be able to shelter some of that income and build more retirement money by making annual retirement contributions to a Keogh Plan (up to $45,000 in 2007). Check with your accountant.

Avoid constructive receipt. If you defer receiving income or salary to a later date, usually the following year, but have the option or right to receive the payments now, you have *constructive receipt of income,* which makes the money immediately taxable as income to you.

Bonus money for life insurance. Have your company declare an annual bonus to you to pay for a life insurance policy on your life with your family as beneficiary. The policy can be a new or existing one. The bonus is taxable income to you but tax deductible by the corporation so it's a wash if your tax brackets are the same or near each other. Refer your advisers to Internal Revenue Code Section 162(a). ☐

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Tricia Walsh, Publishing Director
The Business Library
16 Fox Lane, Locust Valley, NY 11560
516-671-8050 • Fax: 516-671-8077
E-mail: triciawalsh@yourbusinesslibrary.com

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