

Abstract: The issue of reasonable owners' compensation often comes up in federal tax inquiries, shareholder disputes and divorce cases. Determining what's reasonable, and therefore defensible in court, requires a financial expert. This article describes some of the ways that such experts do their work.

What is “reasonable compensation,” anyway?

The issue of reasonable owners' compensation often comes up in federal tax inquiries. But it may also be an issue in shareholder disputes and divorce cases.

For instance, minority shareholders or spouses of controlling shareholders may claim that an owner is taking an excessive salary, thereby impairing the value of the business. Alternatively, a nonowner-spouse may claim that a salary is too low, because the owner-spouse is trying to minimize the base on which alimony and child support payments will be calculated.

If you find yourself embroiled in these situations or under fire from the IRS, a financial expert can help you support — or defend against — these claims.

Factors to consider

What's considered reasonable in shareholder disputes or divorces may vary based on state law or legal precedent. A reasonable compensation assessment generally starts by looking outside the company at external market conditions and geographic location. Then, the analysis turns to internal factors, such as the company's size, financial performance and compensation programs. Finally, the individual's contributions to the company, including his or her responsibilities, skills, reputation and experience, are factored into the analysis, along with any personal guarantees from the owner.

An owner may sometimes warrant a salary that's higher or lower than what nonowner-employees receive for similar positions. For example, the U.S. Tax Court recently upheld a combined annual salary of more than \$7.3 million for two owners of a large Arizona concrete contractor. That may seem like a lot of money, but the court ruled that the company's investors still received a reasonable return on investment after owners' salaries were paid. This type of analysis is known as the independent investor test.

Compensation resources

Another type of analysis hinges on comparable salaries paid in arm's length compensation arrangements. Reliable compensation data for a particular industry or geographic market can be found in several public and private salary surveys. A few common examples include Willis Towers Watson's executive salary surveys, the Risk Management Association's Annual Statement Studies[®] and MicroBilt's Integra industry reports. An expert may also consult Economic Research Institute's quarterly salary surveys, the Conference Board's annual executive compensation reports and Dun & Bradstreet's Key Business Ratios on the Web.

Additional industry- or location-specific data can be obtained from salary surveys that break down the data by industry, market or size; industry trade associations and publications; and executive headhunters.

Outside expertise

Deciding what's reasonable for a business owner to receive as compensation can be subjective and sensitive. Our firm can serve as an expert or work with yours to research comparable market data and use it to come up with a defensible estimate.

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