REASONABLE COMPENSATION JOB AID 10/29/2014

APPENDICES

APPENDIX A: SUGGESTED READINGS ON REASONABLE COMPENSATION

Publications:

Reasonable Compensation: Application and Analysis for Appraisal, Tax and Management Purposes, Ron Seigneur & Kevin Yeanoplos, Business Valuation Resources, LLC, Portland, OR (2010)

Valuing a Business, Shannon Pratt, Irwin Press, 5th Edition (2010)

Financial Valuation: Applications and Models, James Hitchner, John Wiley & Co. (2006)

Reasonable Compensation, BNA portfolio 390, 5th Ed, Tax Management (2011)

Reasonable Compensation: Do You Know Where Your Circuit Stands?, Melanie McCoskey, 109 Journal of Taxation, (October 2008)

Court Decisions Focusing on Methodologies

* *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949)

* *Elliotts, Inc. v. Commissioner,* 716 F.2d 1241, 1245-1247 (9th Cir.1983), *rev'g and remanding ,* T.C. Memo. 1980-282

** *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987)

* *Mad Auto Wrecking v. Commissioner*, T.C. Memo. 1995-153

** *Rapco Inc.* v. Commissioner, 85 F.3d 950 (2d Cir. 1996)

* *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

* *Miller & Sons Drywall v. Commissioner*, T.C. Memo. 2005-114

* *Menard v. Commissioner,* 560 F.3d 620 (7th Cir. 2009)

Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Commissioner, T.C. Memo. 2011-74

Watson v. United States of America, 2012 TNT 36-12

* Service has not acquiesced.
** Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue.

APPENDIX B: DATA SOURCES FOR COMPENSATION ISSUES

Below is a listing of salary surveys and other data sources that have been useful in developing reasonable compensation issues.

Resources presently held by the IRS in 2014, Consult the Engineer Reference Toolkit On-Line for updates or changes. Reference purchases can change on a yearly basis.

1. Watson-Wyatt Salary Survey, Published Annually.

2. RMA Annual Statement Studies, Published by Risk Management Assocs. annually.

3. ERI (Economic Research Institute) Salary Survey, Updated Quarterly*

*Engineer Team 1862 has access to the ERI Salary Survey database and can provide data summaries upon request. Email your requests using secure messaging to: Eisha.M.Sheller@irs.gov, or fax directly to Eisha Sheller at 888-295-5121. You may also fax your requests to Engineer Team 1862 at 216-520-7165 but ***email is strongly preferred.*** Information will be returned to you via email.

If you need a further explanation as to what ERI (Economic Research Institute) is, you may access their website at: www.erieri.com.

For a brief overview of ERI's Executive Compensation database go to: http://www.erieri.com/index.cfm?FuseAction=ERIXA.Main.

Go to http://www.erieri.com/methodologies/xa.pdf for information about ERI's methodology.

It is suggested that the ERI data be used with caution and mainly for risk analysis and planning purposes, that is, use it to determine whether or not a reasonable compensation issue might exist. The ERI data is not intended to be the only source of compensation data used in making an excess compensation determination that will be consummated with a proposal for an affirmative adjustment. Rather the examiner should consider and analyze all pertinent reasonable compensation factors when making a reasonable compensation determination.

The role of Engineer Team 1862 is not to interpret or analyze the data, but rather only to gather and compile it with the understanding that the requestor will be using it for risk analysis purposes only.

Current copies of the following sources are not held by the IRS but can often be found at law libraries or libraries with good business reference sections.

4. Top Executive Compensation, Published by the National Industrial Conference Board annually.

5. Executive Compensation and Taxation Coordinator, Published by Research Institute of America (RIA) annually.

6. Almanac of Business & Industrial Financial Ratios by Leo Troy, Published by Prentice-Hall annually.

7. General financial analysis of companies by industry organized by Standard Industry Code.

8. Industry Norms and Key Business Ratios, Published by Dun & Bradstreet Credit Services annually.

There are also various industry specific salary surveys and studies available from trade associations and consulting firms. In using any of these data sources, it is important to know the methodology and background for the collection of the data.

APPENDIX C: INFORMATION DOCUMENT REQUEST SUGGESTIONS

These are examples only and should be customized for your specific taxpayer and facts. Do not simply submit all of these requests unless pertinent to your case.

If working with an LB&I Revenue Agent, it is recommended to emphasize that they are responsible for meeting the requirements for issuing IDRs as contained in the LB&I Commissioner's directive issued on November 4, 2013 and effective on March 3, 2014.

Example 1: This Information Document Request may be issued to explore the role of various officers in the going concern of the enterprise.

Please provide the following information for each officer:

1. The role of the officer, director, trustee or key employee in the organization.

    a. Position(s) held;
    b. Nature, extent, and scope of responsibility;
    c. Duties (Marketing, Logistics; etc.), and hours per week in each discrete job area;
    d. Total hours per week;
    e. Material changes, if any, in each of the above over the last five (5) years;
    f. Copies of employment, consulting and non-compete agreements in effect during the last five (5) years;
    g. Professional qualifications.

2. Results of the officer's efforts.

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

3. Does the officer have any other business relationship with the entity other than their official internal role? If so, what is it?

4. If the officer is also shareholder of the company or derives any income as a result of having an ownership interest, provide details as to his/her ownership interest in the company.

5. Does the company carry "Key Person Insurance" on the officer and, if so, what is the amount of that insurance?

Example 2: This Information Document Request may be issued to ascertain information about the character and condition of the enterprise paying compensation to an employee for services performed during the years under examination.

Please provide the following information:

- Please provide copies of the audited financial statements (i.e., income statement, balance sheet, and statement of cash flows) for the organization for the past five years, including all footnotes, addenda, and appendices. If audited statements are not available for any or all of the past five years, please provide copies of the financial statements for book purposes for the past five years.

- Please provide data indicating the average number of employees and the number of employees at year end for each of the past five years.

- Please provide a brief explanation of the activities and functions of your organization. If there have been material changes in these activities and functions during the past five years, please provide a description of these changes. Also please identify your key competitors in the marketplace.

- Please identify and describe local and national economic factors and conditions which are particularly important in affecting the financial condition of your organization. Which of the following would most accurately characterize your organization over the past five years: in expansion mode, stable mode, or downsizing?

- During the past five years, has your organization been subject to or the beneficiary of any extraordinary events? If so, please describe those events and their specific impact on your organization.

Example 3: The purpose of this Information Document Request is to begin gathering information regarding officer compensation and the method of calculating such for use in making comparisons with compensation paid for similar positions in similar entities.

Please provide the following information for each officer:

1. What time of the year was the officer's compensation determined?
2. Were surveys, outside data, or outside expert reports used to determine the compensation amount? If so, please provide the following information:

    a. What sources of data were used for the comparative analysis?
    b. Explain how guideline entities were chosen.
    c. How many entities were included in the survey where the guideline entities were chosen?
    d. Please provide the analysis conducted, i.e. report, summary, etc.

3. Did the compensation involve bonuses? If so, please provide the following information:

   a. Provide the detail formulas for calculating bonus amounts.
   b. How were the formulas derived and who derived them?
   c. Is there any correlation between organizational performance, i.e. the number of new accounts, and officer's compensation? If so, please provide the agreement.

4. Does the officer have access to an organization provided vehicle? If so, please describe the vehicle, the terms of the agreement and provide written documentation if available.

5. Does the officer have extra insurance benefits not available to non-executive employees? If so, please explain the terms in detail and the monetary amount of each.

6. Does the officer have access to any vacation property owned by the organization? If so, what are the terms of the agreement? Were there any transfers of the property during the period under examination that involved the subject individual? If so, was that transfer an arms-length deal made at fair market value?

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

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

Officer	Fiscal Year	Base Salary	Bonus	Contribution to Pension and/or Profit Sharing	Other Compensation and Fringe benefits	Total
CEO	Year 1 Year 2 Year 3 Year 4					
2nd in command	Year 1 Year 2 Year 3 Year 4					
3rd in command; Etc.	Year 1 Year 2 Year 3 Year 4					

Example 4: This Information Document request may be issued for the purpose of investigating the independence of the compensation setting process for a relevant employee:

1. If the compensation policy for an employee is available in written form, please provide all versions of that policy that cover the examination period.

2. Who approved the employee's compensation policy? Was the compensation for officers set by the officer(s) or by the board of directors or by some other individuals or groups? Please specify the identity of the approver(s).

3. What is the composition of the board of directors and how was it determined?

4. How are board members elected or selected? If elected, what is the election process and what are the eligibility criteria for voting?

5. Describe whether there are familiar/business relationships among the board members? Among the board members and any of the five most highly compensated officers, trustees or key employees?

6. Are any board members, officers, trustees and/or key employees also board members or officers of any other entity that does business with X? If so, what entity and what is the business relationship of that entity with X?

7. How was the compensation policy determined? Was the policy based on any specific reference sources or by comparison to employees in any other organizations? If so, what references or what comparable organizations were used?

8. When was the employee's compensation determined? Was the policy in force at the beginning of the individual years in the examination period or did it change during the course of one or more years? If it changed when did it change, how did it change and why did it change?

9. Is the compensation of any officers, trustees or key employees based on performance? If so, how is performance measured and how are those measures factored into compensation levels?

10. Provide any and all minutes of board, board committee or organization committee deliberations regarding setting officer(s) or approving compensation.

Example 5: This Information Document Request may be issued to gather information on the relationship of the compensation paid to X, Y and Z in comparison to the compensation paid to other key employees in the organization.

Please provide the following information:

1. Organization Chart - Please provide an organization chart of the entity showing the lines of authority and identifying the responsible persons, their job title, and their area of authority.

2. Employee list - Please provide a list of employees with compensation of more than $XXXXX per year, their job title and annual salary

3. Officers, Directors, Managers - In addition to job title and annual salary, for Officers, Directors, Managers and Key Employees, please provide the following:

   a. Description of duties and responsibilities.
   b. Number of direct reports.
   c. Amount of time devoted to job.
   d. Summary of background and experience including any other jobs held in the past 5 years.
   e. Copy of employment contract.

APPENDIX D: FINANCIAL ANALYSIS - EXAMPLE

In this example, the subject company's financials will be compared using the Risk Management Association (RMA) data.
Search the NAICS code that matches the subject company's industry.

Subject Company Income Statements	Fiscal year Ending mm/dd/yyyy	As a % of Sales
Net Sales	$62,189,729	100.00%
Cost of Sales	$54,848,901	88.20%
Gross Profit	$7,340,828	11.80%
Operating Expenses		
Selling, General & Admin Expenses	$5,453,859	8.77%
CEO Salary	$1,425,000	2.29%
	$6,878,859	11.06%
Operating Income	$461,969	0.74%
Other Income (Expense)	($369)	0.00%
Income Before Taxes	$461,600	0.74%
Provision for Taxes	$184,739	0.30%
Net Income	$276,861	0.44%

Subject Company Balance Sheet	Fiscal Year Ending mm/dd/yyyy	Percentage
Assets:		
Current Assets	$3,300,913	72.32%
Other Investments	$171,151	3.75%
Property, Plant and Equipment	$1,092,265	23.93%
Total Assets:	$4,564,329	100.00%

Liabilities & Stockholders' Equity:		
Current Liabilities	$3,761,737	82.42%
Long-term debt	$83,723	1.83%
Total Liabilities:	$3,845,460	84.25%
Preferred Stock	$230,000	5.04%
Common Stock	$15,800	0.35%
Additional Paid-In Capital		0.00%
Retained Earnings	$473,069	10.36%
	$718,869	15.75%
Less Treasury Stock		0.00%
Total shareholders' Equity	$718,869	15.75%
Liabilities + Stockholders' Equity:	$4,564,329	100.00%

Calculation of ratios:	Fiscal Year Ending mm/dd/yyyy
Sales growth (decline)	9.8%
Income, operations growth (decline)	76.8%
Profit before taxes growth	85.9%
CEO salary growth (decline)	43.5%
Retained earnings growth	78.8%
Net worth (equity) growth	40.8%
Gross profit/net sales	11.8%
Operating profit/net sales	0.7%
Profit before taxes/net sales	0.7%
Current ratio	0.88
Debt/worth (total liab./owner's equity)	5.35
% Profit before taxes/tangible net worth	64.2%
% Profit before taxes/total assets	10.1%
Sales/total assets	13.63
% officers' comp/sales	2.3%

RMA Data:

	RMA Data	Taxpayer Ratio	Taxpayer vs. RMA Data	
Total Liab.as % of (Liab+Equity)	67.20%	84.25%	17.05%	Unfavorable
Net Worth as % Total Assets	32.80%	15.75%	-17.05%	Unfavorable
Gross Profit/Net Sales %	16.30%	11.80%	-4.50%	Unfavorable
Operating Profit/Net Sales %	1.90%	0.74%	-1.16%	Unfavorable
Profit Before Taxes/Net Sales %	1.80%	0.74%	-1.06%	Unfavorable
Current ratio				
Upper quartile	1.6		-0.7	
Median	1.2	0.9	-0.3	Lower than median
Lower quartile	1.0		-0.1	
Debt/Worth (Tot. Liab/Owner's Equity)				
Upper quartile	1.2		4.1	
Median	2.4	5.3	2.9	Higher than median
Lower quartile	5.6		-0.3	
% Profit before taxes/tangible net worth				
Upper quartile	36.30%		27.91%	
Median	23.10%	64.21%	41.11%	Favorable
Lower quartile	10.80%		53.41%	
% Profit before taxes/total assets				
Upper quartile	13.40%		-3.29%	
Median	8.40%	10.11%	1.71%	Higher than median
Lower quartile	1.90%		8.21%	
Sales/Total Assets				
Upper quartile	7.4		6.2	
Median	5.2	13.6	8.4	Favorable
Lower quartile	3.7		9.9	

RMA Data:

	RMA Data	Taxpayer Ratio	Taxpayer vs. RMA Data	
% Officers', Directors', Owners' Comp/Sales				
Upper quartile	0.90%		1.39%	
Median	1.50%	2.29%	0.79%	Unfavorable
Lower quartile	2.40%		-0.11%	

Based on this comparison, taxpayer's financial ratios are weaker. Taxpayer may be under-capitalized.

After further factual development, the equity level may be increased and the CEO salary may be adjusted to bring taxpayer's financial ratios in line with the industry.

Note: This is just an example. RMA does not recommend using its data as absolute norms for a given industry. The officers, directors, owners' compensation/sales ratio "include total salaries, bonuses, commissions, and other remuneration to all officers, directors, and/or owners of the firm during the year covered by the statement".[1]

[1] *The Risk Management Association annual statement studies Financial Ratio Benchmarks 2010, 2011* page 20.

APPENDIX E: MARKET APPROACH - EXAMPLE.

Comparisons were made between taxpayer and 10 guideline companies. The guideline companies are assumed to be reasonably comparable to the taxpayer's business.

Company	Total Sales ($million)	Profit ($mil)	Profit % of Sales	Return on Assets	Return on Equity	Officer's Compensation	(as %) Officer's comp/ Sales	(as %) Officer's comp/ Profit
Comparable 1	$538.4	$30.2	5.6%	15.3%	18.2%	$649,209	0.12%	2.14%
Comparable 2	$1,621.5	$50.3	3.1%	6.6%	16.1%	$1,110,730	0.07%	2.21%
Comparable 3	$1,991.0	$59.7	3.0%	4.2%	6.2%	$1,070,392	0.05%	1.78%
Comparable 4	$605.4	$23.0	3.8%	7.4%	11.5%	$528,636	0.09%	2.28%
Comparable 5	$2,238.7	$20.1	0.9%	3.3%	12.1%	$760,182	0.03%	3.86%
Comparable 6	$405.1	$10.5	2.6%	3.6%	9.7%	$204,731	0.05%	1.93%
Comparable 7	$662.6	$84.2	12.7%	20.9%	24.8%	$550,000	0.08%	0.65%
Comparable 8	$895.3	$17.9	2.0%	6.8%	16.3%	$799,366	0.09%	4.39%
Comparable 9	$541.5	$15.2	2.8%	4.7%	8.8%	$655,750	0.12%	4.26%
Comparable 10	$418.5	$0.4	0.1%	0.0%	0.1%	$364,000	0.09%	182.00%
Average	$991.8	$31.2	3.7%	7.3%	12.4%	$669,300	0.08%	20.55%
Median	$634.0	$21.6	2.9%	5.7%	11.8%	$652,480	0.09%	2.25%
Taxpayer:	$36.2	$0.5	1.4%	1.2%	19.1%	$1,200,000	3.32%	240.00%
Taxpayer vs. Comparables	Smaller		Worse	Worse	Better		Higher	Higher

The above example indicates that the taxpayer was at a weaker financial position than the comparable companies. The officer compensation might be in excess. Adjustment to the compensation could be made to bring the ratios in line with the industry and the competitors.

In this example, only limited data were used. In practice, a more detailed financial review should be performed. Financial ratios may include but not be limited to profitability ratios, efficiency ratios, liquidity ratios, solvency ratios, etc. The ratios can be used to assess whether the taxpayer's financial performance is stronger, similar, or weaker as compared to the industry and competitors.

Financial information for prior years of the taxpayer, competitors, and industry can assist in determining whether or not the taxpayer is having a "typical" year or one which has been "exceptional", in either a positive or a negative direction.

In this example, the taxpayer is much smaller than the public comparable companies. This is typical in that it is difficult to get public information for small companies.

Return on equity is presented in this example. Be aware that the taxpayer's book equity must be adjusted to the fair market value which is often not available for private companies. Return on equity will not be meaningful if the book equity does not reflect fair market value. See the Income Approach for further discussion.

APPENDIX F: INCOME APPROACH - EXAMPLE.

In this example, the sole-shareholder of the taxpayer company is also the CEO. It is assumed that the fair market value of the company is known at the beginning and at the end of each year.

	Year 1	Year 2	Year 3	Year 4
Sales:	110,000,000	115,000,000	118,000,000	113,000,000
Net cash flow:	4,100,000	4,280,000	4,460,000	4,990,000
Dividend:	100,000	100,000	150,000	100,000
CEO compensation:	2,200,000	2,500,000	2,700,000	2,800,000
Fair Market Value (FMV) of the company				
Beginning of the year:	14,000,000	16,000,000	19,000,000	20,000,000
End of the year:	16,000,000	19,000,000	20,000,000	20,000,000

Required rate of return is assumed to be 20%; a return that a "hypothetical independent investor" would expect based on comparisons with public company competitors and industry expectations.

NOTE: How to develop a required rate of return is beyond the scope of this example.
Please contact an engineering specialist for assistance in developing a required rate of return.

The following worksheet uses taxpayer’s compensation and financial information to compute the return on equity. The return is then compared with what a "hypothetical independent investor" would require as return on equity.

The investor's return, in this example is from appreciation and dividends.

	Year 1	Year 2	Year 3	Year 4
FMV of stock:				
Beginning of year	14,000,000	16,000,000	19,000,000	20,000,000
End of year	16,000,000	19,000,000	20,000,000	20,000,000
Appreciation	2,000,000	3,000,000	1,000,000	0
Dividends	100,000	100,000	150,000	100,000
Return	2,100,000	3,100,000	1,150,000	100,000
Company annual % return	15%	19%	6%	1%
Investor required % return	20%	20%	20%	20%

Notes: Annual % return is computed using the annual investor's return and the beginning year FMV:
(e.g. year 2 Annual % Return = 3,100,000 / 16,000,000 = .1938 = 19%.

The calculation indicates that a hypothetical independent investor's return in the company is lower than 20%, the required rate of return. This addresses the "hypothetical independent investor" as raised in *Elliotts v.Commissioner*, 716 F.2d 1241, 1245-1247 (9th Cir. 1983), reversing and remanding T.C. Memo 1980-282.

APPENDIX G: COURT CASES RELATING TO PRIOR YEARS' UNDER-COMPENSATION

Under-compensation for prior years is a common organizational defense for high current year compensation

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Estate of Wallace v. Commissioner, 965 F.2d 1038 (11th Cir. 1992)

American Foundry v. Commissioner, 59 T.C. 231 (1972), *aff'd in part and rev'd in part,* 536 F.2d 289 (9th Cir. 1976), *acq.* 1974-2 C.B. 1

Perlmutter v. Commissioner, 44 T.C. 382 (1965), *aff'd*, 373 F.2d 45 (10th Cir. 1967)

* *R.J. Kremer Co. v. Commissioner*, T.C. Memo. 1980-69

Dixo Co., Inc. v. Commissioner., T.C. Memo. 1968-133, *acq.* 1969 AOD LEXIS 337

Pacific Grains, Inc. v. Commissioner, T.C. Memo. 1967-7, *aff'd,* 399 F.2d 603 (9th Cir. 1968)

Nelson Brothers, Inc. v. Commissioner, T.C. Memo. 1992-726

* *Standard Asbestos Manufacturing v. Commissioner*, T.C. Memo. 1958-42, *aff'd in part and rev'd in part,* 276 F.2d 289 (8th Cir. 1960)

Willmark Service System, Inc. v. Commissioner, T.C. Memo. 1965-294, *aff'd,* 368 F.2d 359 (2d Cir. 1966)

* Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue.

APPENDIX H: COURT CASES RELATING TO MULTIPLE JOBS ("Many Hats")

Employee performing multiple jobs within the organization is a common organizational defense for high compensation levels.

Estate of Wallace v. Commissioner, 965 F.2d 1038 (11th Cir. 1992)

* *Dockery v. Commissioner*, T.C. Memo. 1982-509

* *Richlands Medical Association v. Commissioner*, T.C. Memo. 1990-660, *aff'd,* 953 F.2d 639 (4th Cir. 1992)

* *Ken Miller Supply v. Commissioner*, T.C. Memo. 1978-228

* *C.A. White Trucking v. Commissioner*, T.C. Memo. 1977-6, *aff'd,* 601 F.2d 867 (5th Cir. 1979)

* *Hendricks Furniture v. Commissioner*, T.C. Memo. 1988-133

* Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue.

APPENDIX I: EXAMPLE OF A NOT-FOR-PROFIT ANALYSIS (UNIVERSITY SECTOR)

The following discussion illustrates the approach to analyzing compensation issues in the tax-exempt sector using the example of private colleges and universities. For these issues, the IRS Valuation Analyst works closely with the assigned TE/GE examiner. In addition, an Employment Tax Examiner or an Employee Plans Agent or both should be considered for the Exam team. The Valuation Analyst focuses on reasonable compensation while the other examiners consider other aspects of compensation having potential tax ramifications.

EXAMINATION PLANNING

Reasonable Compensation Determinations

The valuation approaches to establishing reasonable compensation for tax-exempt entities are the same as those used for taxable entities: the market, the income, and the cost approaches. These approaches are applied and then reconciled to determine Reasonable Compensation.

A prototypical examination plan for a reasonable compensation issue may include the following steps:

1. Plan on preparing a complete compensation analysis using as many data sources and analysis approaches as is feasible, with a minimal reliance on summary figures from databases.
2. Consider the appropriate market population for tax-exempts; generally speaking, we would start with both taxable and tax-exempt comparables (which is expressly permitted in the Treas. Reg. § 53.4958-4(b)(1)(ii)(A)) and make an appropriate decision as to what comparable set is most appropriate for the specific facts and circumstances.
3. Reference the most reasonable of comparables, striving for at least 5 comparables if possible; comparables must consider both the position being evaluated (actual activities performed) and the entity in which the position exists.
4. Make appropriate adjustments to the comparable data to reflect the subject and to fully explain the logic of those adjustments.
5. Perform some type of a multi-factor analysis such as that of the 5th Circuit in *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987) (Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue).
6. Consider the viewpoint and the financial requirements of an independent investor as was done by the 2d Circuit in *Rapco Inc.* v. Commissioner, 85 F.3d 950 (2d Cir. 1996) (Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue).
7. Focus on total compensation rather than its individual parts as was made clear by the 5th Circuit in *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987) (Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue).
8. Avoid analyzing isolated time periods without considering long-term patterns, especially where a bonus plan is in place. *See Dexsil Corp. v. Commissioner*, 147 F.3d 96 (2d. Cir. 1998) (Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue).

9. Stay objective and resist the temptation to offer subjective opinions. *See Dexsil Corp. v. Commissioner*, 147 F.3d 96 (2d. Cir. 1998) (Court agreed with Service position that compensation was unreasonable, but disagreed on amounts considered reasonable compensation for years at issue); *Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Commissioner,* T.C. Memo. 2011-74.

Potentially Taxable Fringe Benefits & Authorities

College and university executives may receive funds in many different forms including wages, bonuses, service awards, scholastic awards, and honoraria, as well as non-monetary compensation such as services or property. For many university presidents, as a condition of their employment and contained within their employment contracts, there is the **requirement** they live in the president's mansion and use a university-provided vehicle. If these are requirements of their employment, then these fringe benefits are not taxable and are not reported on their W-2s. Other fringe benefits may be taxable and need to be considered both as part of the overall analysis and in isolation to make sure that the proper tax treatment is being applied. Some areas to consider in examination planning are the following:

Country Club Membership:
I.R.C. §§ 61, 162(a), 274(a)(3) and (d)(2), 132(d)
Treas. Regs. §§ 1.274-2(a)(2) and 1.132-5(s)

Employer Provided Vehicle:
I.R.C. §§ 61, 274(d)(4) and 132(d)
Treas. Regs. §§ 1.61-21(d) and 1.132-5(b)

Group Term Life Insurance (Premium on Insurance> $50K):
I.R.C. § 79(a)

University Provided Housing & Authorities:
I.R.C. § 61; Treas. Reg. § 1.61-21(a)(1) – Generally included in gross income.
I.R.C. § 119(a) – Excludes meals or lodging furnished for the convenience of the employer.
I.R.C. § 119(d) – Excludes qualified campus lodging.
I.R.C. § 119(d)(2) provides an exception for inadequate rent.
I.R.C. § 119(d)(3) defines qualified campus lodging.

Athletic Coach Sports Camps:
The fair rental value of certain athletic facilities (football, soccer, or baseball fields; basketball courts) provided to coaches at no charge may be included in their compensation.
I.R.C. §§ 61, 3401(a), 3306(b) and 3121(a)
Treas. Regs. §§ 1.61-1, 31.3121(a)-1(e), 31.3401(a)-1(a)(4) and 31.3306(b)-1(e)

I.R.C. § 4958 considerations:
Athletic coach may not be a disqualified person (DP) subject to I.R.C. § 4958

<u>Severance Payments and Authorities</u>:
I.R.C. § 3121(a) – defines the term wages to mean all remuneration for employment

Treas. Reg. § 1.3121(a)-1(i) – remuneration for employment, unless such remuneration is specifically excepted under I.R.C. § 3121(a) or Treas. Reg. § 31.3121(a)-1(j), constitutes wages even though at the time paid, the relationship of employer and employee no longer exists.

Rev. Rul. 74-252, 1974-2 C.B. 287, holds that all payments made by an employer to an employee on account of involuntary separation from the service of the employer are wages for purposes of the FICA, the FUTA, and federal income tax withholding.

Mayberry v. United States, 151 F.3d 855, 860 (8th Cir. 1998): Found that a settlement award received by a former employee constituted wages. Opinion refers to § 3121(b): "Employment means any service, of whatever nature performed . . . by an employee for the person employing him . . . ." The courts have taken the position that termination payments and payments made by employers to former employees are wages for employment tax purposes in numerous cases: for example, *Associated Electric Cooperative, Inc. v. United States*, 226 F.3d 1322 (Fed. Cir. 2000) (payments to employees under a voluntary "early out" plan were wages subject to FICA taxes); *Abrahamsen v. United States*, 228 F.3d 1360 (Fed. Cir. 2000) (payments made under an employer's exit-incentive programs were wages subject to FICA taxes); *Hemelt v. United States*, 122 F.3d 204, 209-10 (4th Cir. 1997) (compensation for lost wages was subject to FICA taxes); *Gerbec v. United States*, 164 F.3d 1015, 1025-27 (6th Cir. 1999) (settlement award representing a loss in back wages and future wages that otherwise would have been paid was wages for FICA purposes).

<u>Severance Payments – Contract Cancellations</u>:
Revenue Ruling 2004-110, 2004-2 C.B. 960: An amount paid to an employee as consideration for cancellation of an employment contract and relinquishment of contract rights is ordinary income, and wages for purposes of FICA, FUTA, and Federal income tax withholding.

<u>Severance Payments – Tenure Buyouts</u>:
University of Pittsburgh v. United States, 507 F.3d 165 (3d Cir. 2007): Tenure buyouts to university professors are wages for FICA tax purposes. *But see North Dakota State University v. United States*, 255 F.3d 599 (8th Cir. 2001), *nonacq.,* AOD 2007-01, holding that tenure buyouts to university professors are <u>not</u> wages for FICA tax purposes. AOD 2007-01: The Service will follow *North Dakota State University* only within the Eighth Circuit and only with respect to cases that have the exact facts as that case and only to the extent that payments were made before January 12, 2005.

<u>Tuition Waivers</u>:
I.R.C. § 117(d) excludes any *qualified tuition reduction* from income, defined as:
The amount of any reduction in tuition provided to an employee of an organization described in I.R.C. § 170(b)(1)(A)(ii) for education below the graduate level at such organization or another organization described in I.R.C. § 170(b)(1)(A)(ii).

For the employee or any person treated as employee under the provisions of I.R.C. § 132(h), I.R.C. § 117(d)(3) describes the non-discrimination rules applicable to highly compensated employees. *See* PLR 9621033 (Feb. 26, 1996).

Tuition Waivers – Exception:
Graduate students engaged in teaching or research activities for an educational organization described in I.R.C. § 170(b)(1)(A)(ii) may also exclude reduction in tuition at that educational organization under I.R.C. § 117(d).

I.R.C. § 127(a) excludes from gross income the first $5,250 of employer-paid expenses under an educational assistance program for employees. This $5,250 is in addition to amounts excluded under I.R.C. § 117(d). *See* I.R.C. § 127(c)(6).

See Revenue Ruling 86-69, 1986-1 C.B. 78, finding the provisions of I.R.C. § 117(d)(1) and I.R.C. § 127(a) to be independent, and amounts not excluded under I.R.C. § 127(a) may be excluded under I.R.C. § 117(d)(1).

Tuition Waivers - Authorities and Rulings:
I.R.C. § 117(d)
I.R.C. §§ 127(a), 132(j)(8), and 132 (l)
PLR 9040045 (July 10, 1990)
FSA 200231016 (Mar. 13, 2002)

Graduate Tuition Waivers, Remissions, or Reductions - Free or discounted graduate level tuition offered to the employees of educational organizations. Audit techniques for graduate tuition issues include: Identifying names of students who received graduate tuition benefits, determining students' titles and job descriptions, and the amounts of tuition fees waived.

Specific Issues/Concerns with Loans

Loans **-** No Interest, Low Interest or Disguised Compensation: Loans may have been at no interest or low interest and, in some instances, the terms have been such that the loan is disguised compensation. This issue can occur in both Not-for-Profits and For-Profits. Some factors that are indicative of a bona fide loan include: the existence of a promissory note, cash payments according to a specified repayment schedule, interest charged, and security for the loan.

Loans to executives should be reviewed to determine if they are bona fide and to determine if the terms are being followed.

- Is there a written document detailing the terms of the loan, such as a formal repayment schedule?
- Is repayment required over a certain number of years or on demand?
- Is the interest rate at market or at a below market rate of interest?
- Is the loan listed on the entity's balance sheet as a receivable?
- Are the terms of the loan being followed? For example, are payments being made monthly? Is the executive making payments?, etc.

The loan terms could include forgiveness of part or the entire loan if the executive remains with the entity for a certain number of years, etc. Such arrangements may constitute compensation income rather than bona fide loans.

I.R.C. § 7872 deals with the treatment of loans having interest rates, that are below the prevailing market rate as of the date of the loan. It specifically applies to compensation-related loans, which include below market loans directly or indirectly between an employer and an employee. In general, § 7872 operates to impute interest on below market loans. In the case of employer/employee loans, the employer is treated as transferring the forgone interest to the employee as additional compensation and the employee is treated as paying interest back to the employer.

Different rules apply depending on whether a loan is a demand loan (§ 7872(a)) or a term loan (§ 7872(b)). A demand loan is a below-market loan if it does not provide for an interest rate at least equal to the applicable federal rate. A term loan is a below-market loan if the present value of all amounts due on the loan is less than the amount of the loan (i.e., the yield to maturity is lower than the applicable federal rate).

Demand Loans: With respect to demand loans, the imputed interest payments and deemed transfers of additional compensation are treated as transferred on the last day of the calendar year.

Term Loans: With respect to term loans, the lender is treated at the time of the loan as transferring the difference between the loan amount and the present value of all future payments required under the loan as additional compensation. The term loan is then treated as having original issue discount (OID) equal to the amount of the deemed transfer of additional compensation and thus, subject to the OID provisions of § 1271 et seq.

There is a de minimis exception from the application of the § 7872 imputation rules for compensation-related loans if all loans between the parties in the aggregate for any day do not exceed $10,000 (§ 7872(d)(3)). The de minimis exception does not apply if one of the principal purposes of the loan is tax avoidance.

There are also a number of exemptions from the application of § 7872 for loans listed in Treas. Reg. § 1.7872-5T – Exempted Loans.

Personal loans to officers and directors of public companies are banned by the Sarbanes-Oxley Act of 2002, which became effective on July 30, 2002. Personal loans outstanding on the date of enactment are not prohibited, provided there is no material modification or renewal of the loan on or after the date of enactment. Neither loans nor an extension of credit can be renewed after the date of enactment of Sarbanes-Oxley. This law does not apply to private companies.

Some loans to executives are essentially disguised compensation based on the terms of the loan. I.R.C. § 61(a)(1) and § 61(a)(12) define gross income to include compensation for services and income from discharge of indebtedness.

Treas. Reg. § 1.61-12(a) provides that if an individual performs services for a creditor, who in consideration for the services cancels the debt, the debtor realizes income in the amount of the debt as compensation for services. Discharge of indebtedness income realized by an employee from an employer under these circumstances is payment in the nature of compensation, and thus is includible in gross income and wages for employment tax purposes.

Issues have been raised regarding loan forgiveness. For example, loans may be forgiven if the employee remains in the employ of the entity for a certain period; loans may call for unusual repayment methods, such as stock in lieu of cash, and extreme repayment dates, such as repayment by the executive's trust upon the death of the executive and his spouse. Whether these arrangements should be considered bona fide loans depends on the specific facts and circumstances.

See Winter v. Commissioner, T.C. Memo 2010-287 (bonus advance held compensation for services).

EXAMINATION CONDUCT AND COORDINATION

It is essential that the assigned examiners work together throughout the examination process to assure that all relevant compensation items are being considered and that such are being consistently treated. If an item is compensatory in nature it should be part of the reasonable compensation analysis. Even though overall compensation, including all such items, may ultimately be deemed reasonable the tax treatment of individual items may still require adjustment. On-going communication and collaboration are critical factors in seeing that a comprehensive compensation examination is performed. If one examiner uncovers an item of a compensatory nature this information should be immediately shared with all other assigned examiners so that it can be appropriately considered in all of the analyses. The Compensation and Benefits IPG Subject Matter Experts (SMEs) are available to provide technical assistance and guidance to aid in working through your Reasonable Compensation issues. The Valuation Analyst cannot work in isolation and be confident that a proper reasonable compensation determination has been made.