

## **Reasonable compensation**

As the owner of an incorporated business, you're probably aware that there's a tax advantage to taking money out of the corporation as compensation (salary and bonus) rather than as dividends. The reason is simple. A corporation can deduct the compensation that it pays, but not its dividend payments. Thus, if funds are withdrawn as dividends, they're taxed twice, once to the corporation and once to the recipient. Money paid out as compensation is taxed only once, to the employee who receives it.

However, there's a limit on how much money you can take out of the corporation in this way. The law says that compensation can be deducted only to the extent that it's reasonable. Any unreasonable portion is nondeductible and, if paid to a shareholder, may be taxed as if it were a dividend. As a practical matter, IRS rarely raises the issue of unreasonable compensation unless the payments are made to someone "related" to the corporation, such as a shareholder or a member of a shareholder's family.

How much compensation is "reasonable"? There's no simple formula. IRS tries to determine the amount that similar companies would pay for comparable services under like circumstances.

Factors that are taken into account include:

- the employee's duties;
- the amount of time required to perform those duties;
- the employee's ability and accomplishments;
- the complexities of the business;
- the gross and net income of the business;
- the employee's compensation history; and
- the corporation's salary policy for all its employees.

There are a number of concrete steps you can take to make it more likely that the compensation you earn will be considered "reasonable," and therefore deductible by your corporation. For example, you can:

- Use the minutes of the corporation's board of directors to contemporaneously document the reasons for the amount of compensation paid. For example, if compensation is being increased in the current year to make up for earlier years in which it was too low, be sure

that the minutes reflect this. (Ideally, the minutes for the earlier years should reflect that the compensation paid in those years was at a reduced rate.)

- Avoid paying compensation in direct proportion to the stock owned by the corporation's shareholders. This looks too much like a disguised dividend, and will probably be treated as such by IRS.
- Keep compensation in line with what similar businesses are paying their executives (and keep whatever evidence you can get of what others are paying—e.g., salary offers to your executives from comparable companies—to support what you pay if you are later questioned).
- If the business is profitable, be sure to pay at least some dividends. This avoids giving the impression that the corporation is trying to pay out all of its profits as compensation.

As in most tax situations, planning ahead avoids problems later. Feel free to contact us if you would like to discuss this or any other aspect of your current or deferred compensation strategies.