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When IRS Calls Pay "Unreasonable"

Long before the huge executive pay packages of the last few decades, the IRS labeled some pay unreasonable and levied extra taxes as a result. Sometimes pay that is too ***low*** is also attacked with–once again–extra taxes as a result. That means pay that's too low or too high can trigger extra taxes. It sounds maddening, but winnowing down the reason pay must be not too low or too high turns primarily on the type of business entity paying the compensation. I'll address pay that is too low in a future column.

Beware Lavish Pay. With most corporations, all pay (to executives as well as rank and file workers) is deducted by the corporation as a business expense. That means no corporate tax is paid on the money. It is deducted, and tax is paid by the recipients. What happens if the corporation pays out $10 million for the CEO when he's really only worth $3 million?

The answer is complicated and depends on many variables. Public companies are subject to rules governing pay over $1 million that must generally be performance-based, but often the corporation can ***still*** deduct the payment. See IRC § 162(m). But the situation is trickier if the business is closely-held.

To take an extreme example, what if Joe owns 100% of the corporation's stock and is the CEO? If Joe will receive all the money in any event, Joe might have the company pay him deductible salary and bonus so he only

pays tax as an individual—the corporation would deduct all that compensation as a business expense.

If the company paid Joe a more modest salary and bonus, the company could have paid him the rest of the money as a dividend. The corporation receives no tax deduction for dividends, so the corporation would first have to pay tax on it. Then Joe would pay personal income tax.

For that reason, the IRS monitors compensation by closely-held companies. With closely-held (especially family) companies, the IRS has a keen eye for who is getting paid too much. The assumption is that some of the money being paid out and called "compensation" is probably a disguised dividend. See Funny Money: Deducting "Reasonable" Compensation.

Some compensation may be labeled as ***unreasonable*** and therefore ruled ***nondeductible*** by the corporation. In closely-held businesses, these steps can help to support treating pay as deductible pay:

- Document compensation arrangements prospectively, not retroactively.
- In setting compensation, take a historical perspective; inadequate compensation in the past may support higher pay now.
- Gather comparative data about similarly situated companies and similarly situated executives, what they do, how much they work, and how much they are paid.
- Consider dividend history and be alert for ''disguised dividend'' arguments where no dividends are paid.
- Consider criteria an independent investor would consider if investing in the company.
- Keep good records and be ready to produce documents if you have to.

For more, see:

Ten Things You Need To Know About 'Reasonable' Compensation

When The Service Claims Compensation Is Unreasonable

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