

Reasonable Compensation for S Corps

Welcome to our webinar!





Paul Hamann
Founder & President, RCReports

Nice to meet you!

- Expert on determining Reasonable Compensation for closely-held business owners
- Educated + 100,000 financial professionals on reasonable compensation and has been published in numerous national and state journals





Big Changes

IRS Launches Study of S Corporation Reporting Compliance

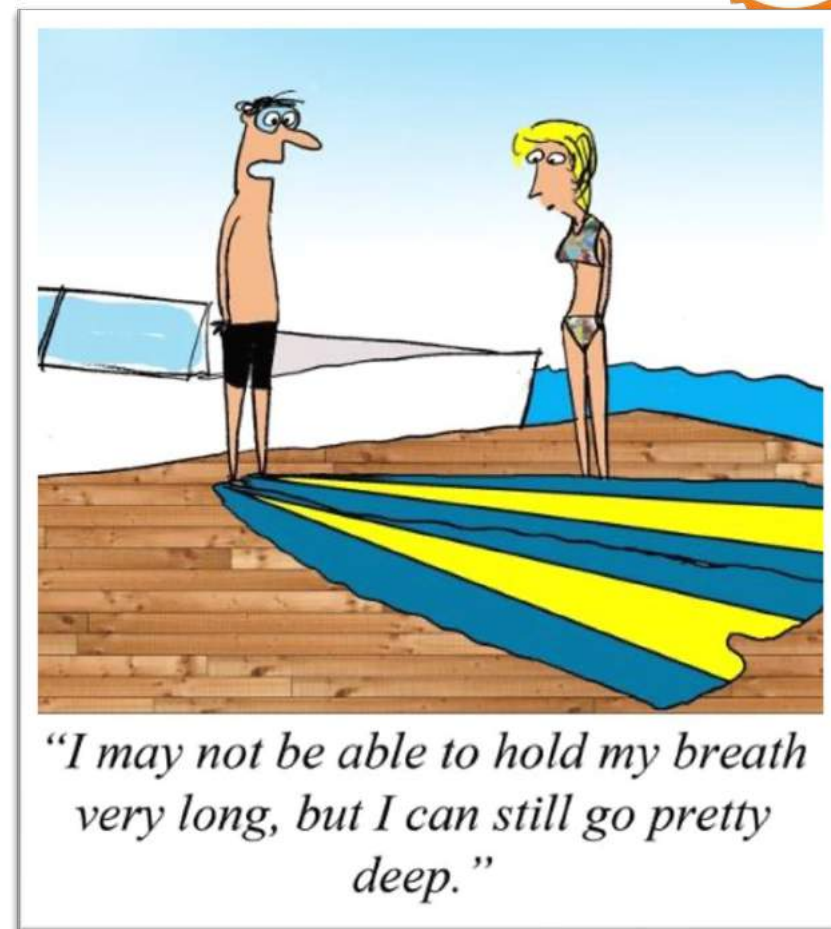


IR-2005-76, July 25, 2005

WASHINGTON — Internal Revenue Service officials announced today the launch of a study to assess the reporting compliance of S corporations. The study, carried out under the National Research Program (NRP), will examine 5,000 randomly selected S corporation returns from tax years 2003 and 2004.





Agenda

- Advantage Distribution V. Wages
- Reasonable Compensation in the courts
- IRS Guidelines
- Profitability V. Distributions
- Reasonable Compensation and the IRS
- Determining Reasonable Compensation
- Tips, Advice, Q&A



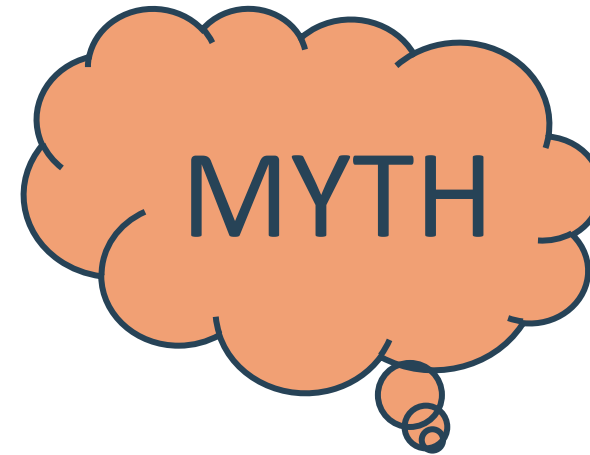
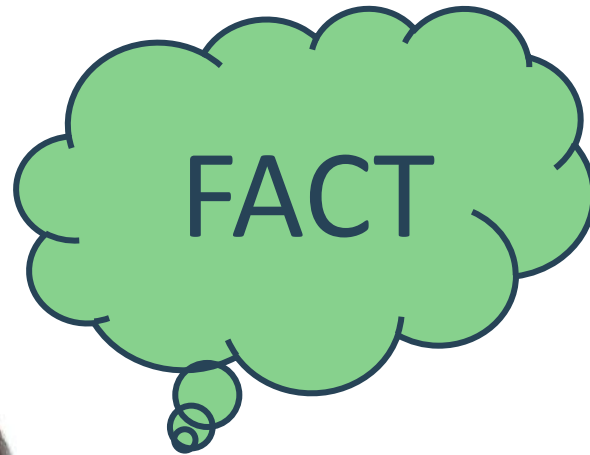


Terms

- Reasonable Compensation = Replacement Cost  
- Reasonable Compensation = FMV Fair Market Value  
- Distributions = Dividends
- Distributions = Loan repayment, Return of basis
- Shareholder-employee (SE) = Corporate officer
- Shareholder-employee (SE) = S Corp owner



Reasonable Compensation for S Corps





Myth:

60/40 Rule or 50/50 Rule

"The 60/40 rule is a simple approach that helps S corporation owners determine a reasonable salary for themselves. Using this formula, they divide their business income into two parts, with 60% designated as salary and 40% paid as shareholder distributions."



Myth:

Industry Rule

Set wages as a percentage of sales or revenue based on industry standards | Payroll as a percentage of Net-Income

"That reasonable salary can be anywhere from 30-50% of the net income from your business."



edwardcollins_upleveled
Edward Collins · 2023-9-6

Myth:

Safe Harbor Rule

Set wages at the Social Security maximum limit

Myth:

Wild A** Guess

"Save employment taxes by setting up your consulting business as an S-Corp. At the lower end you get to decide a fair wage to pay yourself and save social security taxes."



markkohler
Mark J. Kohler · 2023-11-11

Reasonable Compensation for S Corps





Distribution V. Wages/Salary

Wages/Salary = Payroll Taxes

Distributions \neq Payroll Taxes

Substantial Services = Reasonable Compensation



Distribution V. Wages/Salary

Example 1

- Scott Stone 100% of Stone Concrete (S Corp)
- Full Time Employee of Stone Concrete
- \$100,000 income before considering Scott's salary
- Scott takes a \$100,000 salary = taxable income is zero
- \$100,000 wages \longrightarrow 1040





Distribution V. Wages/Salary

Example 1 (Continued)

- Scott and Stone Concrete responsible for Payroll Taxes
 - 7.65% Stone Concrete SS/Medicare = \$7,650
 - 7.65% Scott Stone SS/Medicare = \$7,650
 - State & Federal Unemployment Tax = ???
- **Total Tax Liability** **\$15,300+**

Distribution V. Wages/Salary

Example 2

- Scott Stone 100% of Stone Concrete (S Corp)
- Full Time Employee of Stone Concrete
- \$100,000 income before considering Scott's salary
- Scott takes a \$100,000 distribution
- \$100,000 income \longrightarrow 1040





Distribution V. Wages/Salary

Example 2 (Continued)

- Scott and Stone Concrete Payroll Taxes = \$0.00
- Self Employment Tax = \$0.00
- Income Tax (return of basis) = \$0.00
- Total Tax Liability = \$0.00

Net tax savings \$15,300+



Distribution V. Wages/Salary

Wages/Salary



vs

Distributions





IRS Requirement

“ Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation.

~ Instructions 1120S

199A & QBID

Variables

- Taxable income of the taxpayer and spouse if filing married filing jointly
- Wages reported on Schedule C or from the flow through entity
- If multiple business have the businesses been aggregated.
- Taxable income from each of the businesses
- Guaranteed payments from partnerships
- Type of business
- Filing status
- Net capital gain
- Qualified cooperative dividends
- The basis in qualified property
- REIT dividends



"Chances are 50/50 that it's a total crapshoot, but it could go either way."

Reasonable Compensation in Courts

IRS 25-1*



VS



*Davis v. U.S.

Reasonable Compensation in Courts

DAVID E. WATSON, P.C., V. UNITED STATES OF AMERICA
(2010)



VS





Reasonable Compensation in Courts

Low Salary V. Profit Distributions

- 2002 Profit Distributions = \$203,651
- 2002 Salary = \$24,000
- 2003 Profit Distributions = \$175,470
- 2003 Salary = \$24,000



Reasonable Compensation in Courts

IRS Objected

- Education:
 - Graduate Degree
- Experience:
 - 20 Years
- Time: Full Time
 - (35-45 hours per week)





Reasonable Compensation in Courts

IRS Audit 2007





Reasonable Compensation in Courts

Reasonable Compensation

\$91,044 for 2002

\$91,044 for 2003



Reasonable Compensation in Courts

	2002	2003
Reasonable Compensation	\$91,044	\$91,044
Actual Salary Paid	<u>\$24,000</u>	<u>\$24,000</u>
<u>Re-Characterized</u>	\$67,044	\$67,044

Total Re-Characterization = \$134,088



Reasonable Compensation in Courts

\$48,521

\$20,000



Reasonable Compensation in Courts

Watson V. IRS



Reasonable Compensation in Courts

Ruling in favor of IRS 2010



VS





Reasonable Compensation in Courts

IRS

- Graduate Degree
- 20 Years experience
- Full Time employee

Various Job Duties:

- CPA/Accountant
- Partner
- Re-structured businesses

No Research and No Documentation



Reasonable Compensation in Courts

Appealed



Reasonable Compensation in Courts

Upheld District Courts Ruling 2012



VS





Reasonable Compensation in Courts

Appealed Denied



Take Aways

- Paid Some RC
- IRS did not recharacterize all distributions
- Single Shareholder
- Services only



Reasonable Compensation in Courts

SEAN MCALARY LTD, INC. v. COMMISSIONER (IRS) (2013)



VS





Reasonable Compensation in Courts

McAlary Ltd = Real Estate Company

- 2006 Net Income = \$231,454
- 2006 Distribution = \$240,000
- 2006 Salary = Zero



Reasonable Compensation in Courts

IRS Calculation: \$100,755

- Primary Job Function – Real Estate Broker
- Full Time (12 hour days 6-7 days per week)
- Compared McAlary LTD performance with peers in the real estate industry 🚫



Reasonable Compensation in Courts

IRS Calculation: \$100,755

- **Replacement Cost** – McAlary LTD could expect to pay \$48.44/hour to another individual in exchange for the services Mr. McAlary performed !
- **Fair Market Value** – \$100,755 would be FMV of the services Mr. McAlary performed for his S Corp !



Reasonable Compensation in Courts

IRS Calculation: $\$100,755 = \$48.44 \times 2,080$

- The Bureau of Labor Statistics defines Year-Round, Full-Time employment as **2,080** hours per year.
- 40 Hour Work Week x 52 Weeks/Year
- McAlary often worked 12-hour days with few days off



Reasonable Compensation in Courts

McAlary Calculation: \$24,000


- Compensation Agreement 🚫
- BOD Meeting Minutes 04-01-2004
- Increases Based on Number of Agents





Reasonable Compensation in Courts

Court Calculation: \$83,200



- Various Services 
- Wage Range
- Hourly Wage = \$40.00
- $2,080 \times \$40.00 = \$83,200$



Reasonable Compensation in Courts



Court Calculation: \$83,200 = 2,080 x \$40.00



- **Compensation Agreement** – “We are not persuaded that the remuneration agreement represents a sound measure of the value of the services that Mr. McAlary provided ... The agreement clearly was not the product of an arm's-length negotiation.” 
- **Industry Comparison** – “(IRS Expert) did not explain how a *comparison of compensation measured as a percentage of gross receipts with compensation measured as a percentage of net sales* would aid the Court ... In the end, we do not find this portion of (the experts) report to be persuasive or helpful.” 



Reasonable Compensation in Courts



Court Calculation: \$83,200 = 2,080 x \$40.00


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Reasonable Compensation in Courts



Court Calculation: \$83,200 = 2,080 x \$40.00

- **Various Services** – Management; Supervision; Recruiting; Sales; Advertising; Purchasing; Bookkeeper; Record Keeping... 
- **Experience** – Low; New to the Industry
- **COESS-BLS** – Range \$32.99 to \$64.28

“ Determining an employee's reasonable compensation is dependent upon a number of factors and is far from an exact science.



Reasonable Compensation in Courts

Court Rulings

- Sean McAlary Ltd, Inc. v. Commissioner 2013
- Glass Blocks Unlimited v. Commissioner 2013
- Patrick & Suzanne Herbert v. Commissioner 2012
- David E. Watson, P.C. v. United States 2010
- JD & Associates, LTD v. United States 2006
- Joseph M. Grey Public Accountant, P.C. v. Commissioner 2002**
- Veterinary Surgical Consultants, P.C. v. Commissioner 2003**
- Joly v. Commissioner 2000
- Spicer Accounting, Inc. v. United States 1990
- Joseph Radtke, S.C. v. United States, 1989

Cases in orange are accounting firms
** Clients of Joseph M. Gray

Definition, IRS

“ Reasonable compensation is the value that would ordinarily be paid for like services by like enterprises under like circumstances

~ IRS Code: Section 162-7(b)(3)

“ Reasonable & Services Rendered

~IRS Code 162(a)(1)

- Replacement Cost
- Fair Market Value






IRS Guidelines

Notice of Acceptance as an S Corporation

We would also like to take this opportunity to inform you of your tax obligations related to the payment of compensation to shareholder-employees of S corporations.

When a shareholder-employee of an S Corporation provides services to the S corporation, reasonable compensation generally needs to be paid. This compensation is subject to employment taxes.

 Tax practitioners and subchapter S shareholders need to be aware that **Revenue Ruling 74-44** states that the Internal Revenue Service (IRS) will re-characterize small business corporation dividends paid to shareholders as salary when such dividends are paid to the shareholders in lieu of reasonable compensation for services.

This position has been supported in several recent court decisions.



IRS Guidelines

W-2 or 1099

- Revenue Ruling 74-44; IRC § states:
 - An officer of a corporation is considered an **EMPLOYEE**
- Employee or Independent Contractor
 - Under common-law rules, anyone who performs services for you is your employee *if you can control what will be done and how it will be done*

1099

W-2

IRS Guidelines

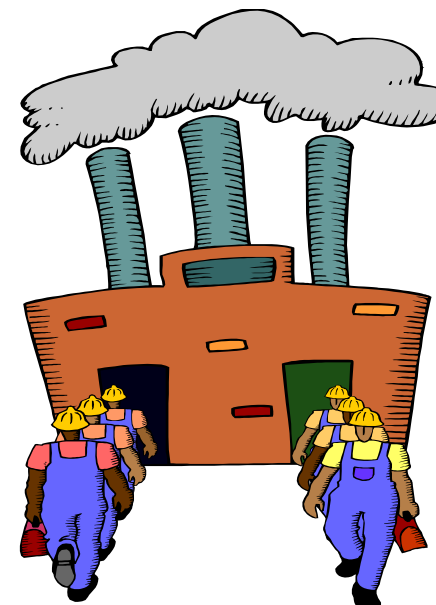
The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation

1. Services of non-shareholder employees
2. Capital and equipment
3. Services of shareholders



IRS Guidelines

Services of non-shareholder employees, or Capital & equipment



IRS Guidelines

Services of shareholder

In addition to the shareholder-employee direct generation of gross receipts, the shareholder-employee should also be compensated for administrative work performed !





IRS Guidelines

INTERNAL REVENUE SERVICE		
IRS		Fact Sheet
Media Relations Office	Washington, D.C.	Media Contact: 202.622.4000
www.irs.gov/newsroom		Public Contact: 800.829.1040

Wage Compensation for S Corporation Officers


FS-2008-25, August 2008

Corporate officers are specifically included within the definition of employee for FICA (Federal Insurance Contributions Act), FUTA (Federal Unemployment Tax Act) and federal income tax withholding under the Internal Revenue Code. When corporate officers perform services for the corporation, and receive or are entitled to receive payments, their compensation is generally considered wages. Subchapter S corporations should treat payments for services to officers as wages and not as distributions of cash and property or loans to shareholders.



IRS Guidelines

Some factors considered by the courts in determining reasonable compensation:

- 1 • Training and experience
- 2 • Duties and responsibilities
- 3 • Time and effort devoted to the business
 - Dividend history
 - Payments to non-shareholder employees
- Timing and manner of paying bonuses to key people
- What comparable businesses pay for similar services
- Compensation agreements 
- The use of a formula to determine compensation

IRS Guidelines

1. Training and experience

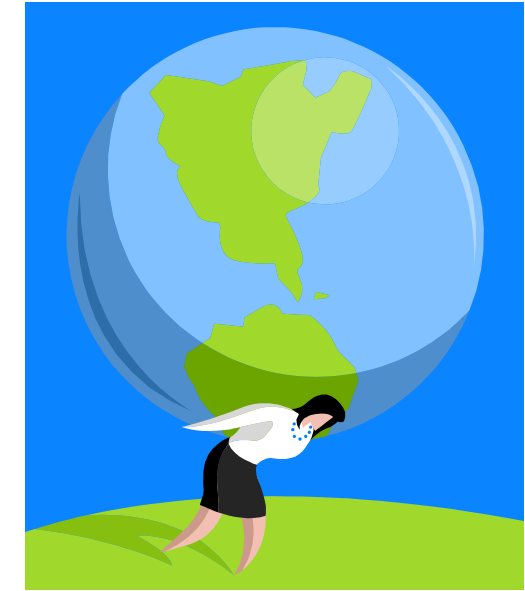


&



IRS Guidelines

2. Duties and responsibilities



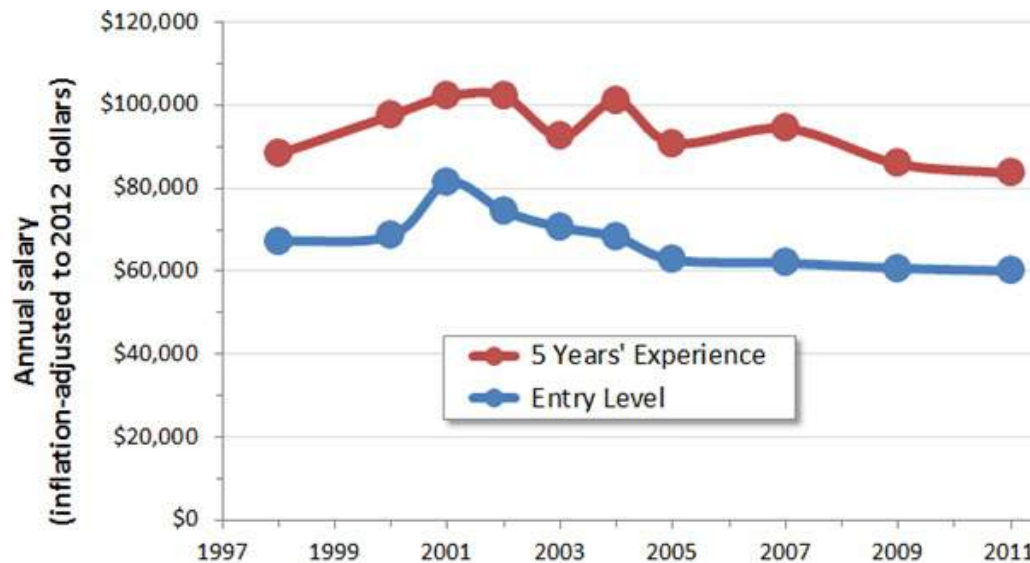
IRS Guidelines

3. Time and effort devoted to the business



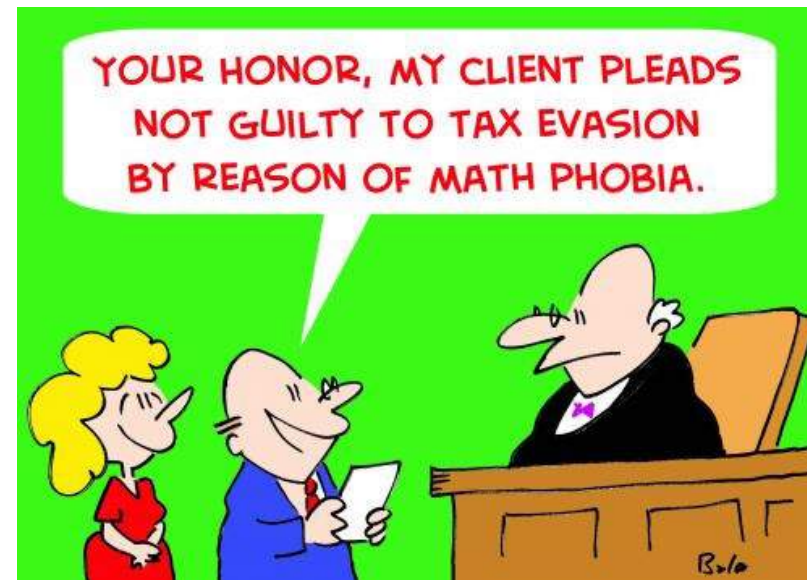
IRS Guidelines

4. What comparable businesses pay for similar services



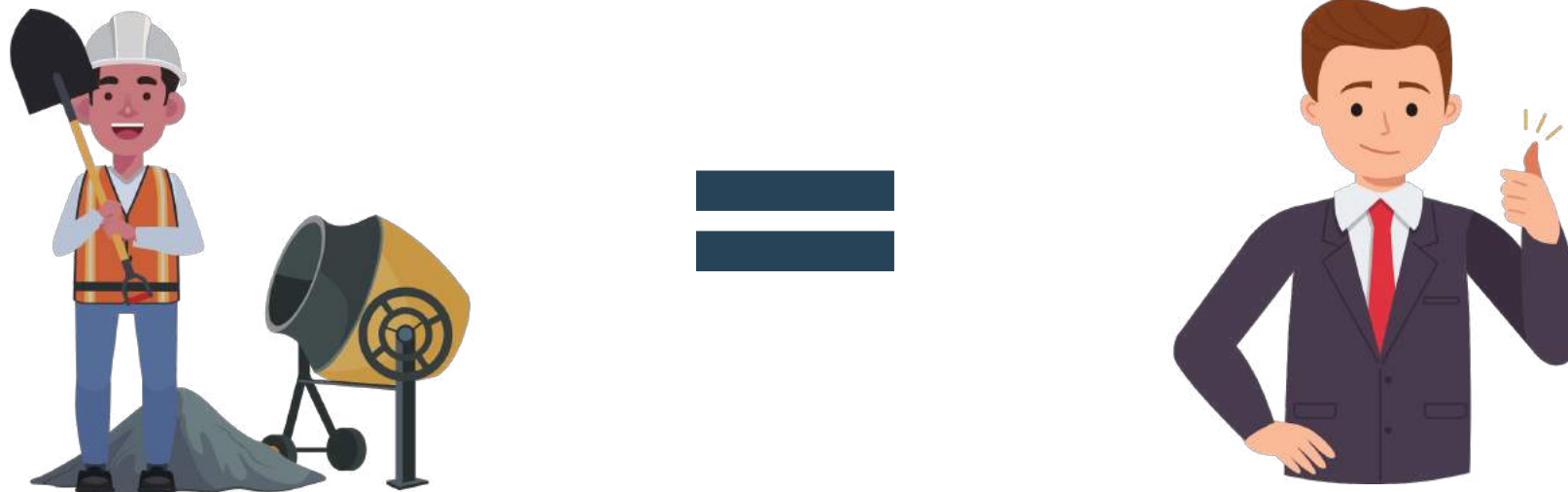
IRS Guidelines

5. The use of a formula to determine compensation



IRS Guidelines

6. Payments to non-shareholder employees



IRS Guidelines

7. Compensation agreements



IRS Guidelines

8. Timing and manner of paying bonuses to key people



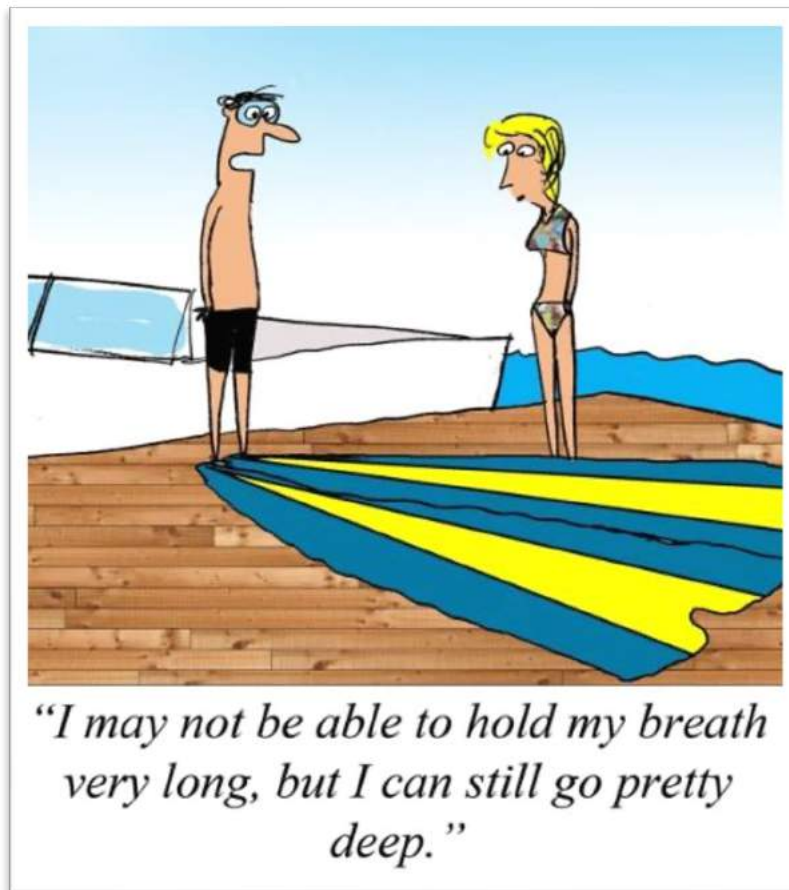


IRS Guidelines

9. Dividend history



Profitability v. Distributions





Profitability v. Distributions

Reasonable Compensation



Distributions



Profitability

“ The amount of reasonable compensation will never exceed the amount received by the shareholder either directly or indirectly.

~ FS-2008-25



Profitability v. Distributions

Example 1

- Scott Stone 100% of Stone Concrete (S Corp)
- Scott's RC figure = \$68,788
- Stone Concrete Net Profit = \$210,000
- Scott takes \$200,000 out of Stone Concrete
- Scott receives wages (RC) of \$68,788
- Scott receives a distribution of \$131,212
\$200,000



Profitability v. Distributions

Example 2

- Scott Stone 100% of Stone Concrete (S Corp)
- Scott's RC figure = \$68,788
- Stone Concrete Net Profit = \$23,000
- Scott takes \$30,000 out of Stone Concrete
- Scott receives wages (RC) of \$30,000
- Scott receives a distribution of \$ 0
\$30,000



Profitability v. Distributions

Example 3

- Scott Stone 100% of Stone Concrete (S Corp)
- Scott's RC figure = \$68,788
- Stone Concrete Net Profit = \$150,000
- Scott takes \$0 out of Stone Concrete
- Scott receives wages (RC) of \$0
- Scott receives a distribution of \$0
\$0



Profitability v. Distributions

Example 4

	Year 1	Year 2	Year 3	Total
Scott RC	\$70k	\$70k	\$70k	\$210k
Net Profit	\$150k	\$175k	\$200k	\$525k
Scott Takes	\$0	\$0	\$500k	
Wages	\$0	\$0	\$210k	
Distribution	\$0	\$0	\$290k	



Profitability v. Distributions

Payroll Tax Savings – Example 4

	Year 1	Year 2	Year 3		Years 1-3
Reasonable Compensation	\$70,000	\$70,000	\$70,000		\$210,000
FICA 12.4% (2024 limit 168,600)	\$8,680	\$8,680	\$8,680		\$20,906
Medicare 2.9% (all)	\$2,030	\$2,030	\$2,030		\$6,090
Medicare Surtax 0.9% (over \$200K)	\$0	\$0	\$0		\$90
	\$10,710	\$10,710	\$10,710		\$27,086
			Total	\$32,130	
				-\$27,086	
			Tax Savings	\$5,044	



Shareholder Loan or Capital Contribution

GLASS BLOCKS UNLIMITED v. COMMISSIONER (IRS) (2013)



VS



How an S Corp can Lose Money and Still be Required to Pay Reasonable Compensation



Shareholder Loan or Capital Contribution

Glass Blocks Unlimited – Fredrick Blodgett

- 2007 Net Income = \$877
- 2007 Transferred in = \$45,000
- 2007 Transferred out = \$30,844
- 2007 Salary = Zero





Shareholder Loan or Capital Contribution

IRS Position

- Transfer in was a contribution to capital (basis)
- Transfer out was a distribution (Return of basis)
- Reasonable Compensation must be paid before a distribution can be made



Shareholder Loan or Capital Contribution

Glass Blocks Position

- Transfer in was a shareholder loan to GBU
- Transfer out was a repayment of the shareholder loan
- Reasonable Compensation does not apply



Shareholder Loan or Capital Contribution

Court Finding

Transfers in question were capital contributions and not bona fide loans

- No Written Agreements or Promissory notes
- No interest charged
- No security (collateral)
- No fixed repayment schedule

example
Promissory Note
I, Local Boy, do promise to pay
Aunty Mele, the sum of \$ 10,000.
Repayment to be made in the
form of 200 equal payments at
5%, payable on the 1st of each
month, starting 8/1/2012 until
the total debt is satisfied. Signed
Local Boy
7/1/2012



Shareholder Loan or Capital Contribution

Court Finding

“ Where the expectation of repayment depends solely on the success of the borrower's business, rather than on an unconditional obligation to repay, the transaction has the appearance of a capital contribution.



Shareholder Loan or Capital Contribution

Math

- Net Income (before) \$877
- Wages **\$-30,844**
- Employment Taxes **\$-2,360**
- Penalty & Interest **\$-1,923**
- 2007 Net Loss (after) **\$-34,250**

Did the IRS Really Lose?

DAVIS v. UNITED STATES (1994)



VS





Did the IRS Really Lose?

DAVIS v. UNITED STATES

Mile High Calcium Owned by:

- Carol L. Davis
- Henry Adams (husband)
- Transfers In and Out 1987-1989
- Assessed Taxes + Interest & Penalties of \$39,220



Did the IRS Really Lose?

DAVIS v. UNITED STATES

Henry Adams – President

- Not an Employee
- No Active Participation
- Worked for outside employers
- Officer in name only
- There is an exception for officers who perform only minor services... (Treas. Reg. § 31.3121(d)-(1)(b))



Did the IRS Really Lose?

DAVIS v. UNITED STATES

Carol L. Davis

- Was an Employee
- 12 hours per month (2.77 per week)
- \$8.00 per hour
- ~~\$39,220~~.....\$647



Reasonable Compensation & the IRS

Form 1125-E

- 2011 Required for Gross Revenue 500k+
 - Collecting data for future comparisons

Form 1125-E only if total receipts are \$500,000 or more. See instructions for definition of total receipts.

(a) Name of officer	(b) Social security number (see instructions)	(c) Percent of time devoted to business	Percent of stock owned		(f) Amount of compensation
			(d) Common	(e) Preferred	
		%	%	%	
		%	%	%	

- Disclosure Standards

- Dollar Amounts must be verifiable
- Taxpayer must be able to demonstrate the origin of the amount claimed
- Taxpayer must be able to show he entered the amount in good faith



Reasonable Compensation & the IRS

Pre 2005...

- Joly v. Commissioner 2000
 - **Established authority to reclassify distributions as wages**
- Veterinary Surgical Consultants, P.C. vs. Commissioner 2001
- Joseph M. Grey Public Accountant, P.C. 2002
 - **Reinforced employment status of shareholders as employees**
- TIGTA 7-2002
 - **The IRS does not always address S Corp officer compensation during examination**
 - **Average W-2 Wages \$5,300**
 - **Average Distribution \$349,323**



Reasonable Compensation & the IRS

IRS Launches Study of S Corporation Reporting Compliance



IR-2005-76, July 25, 2005

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Reasonable Compensation & the IRS

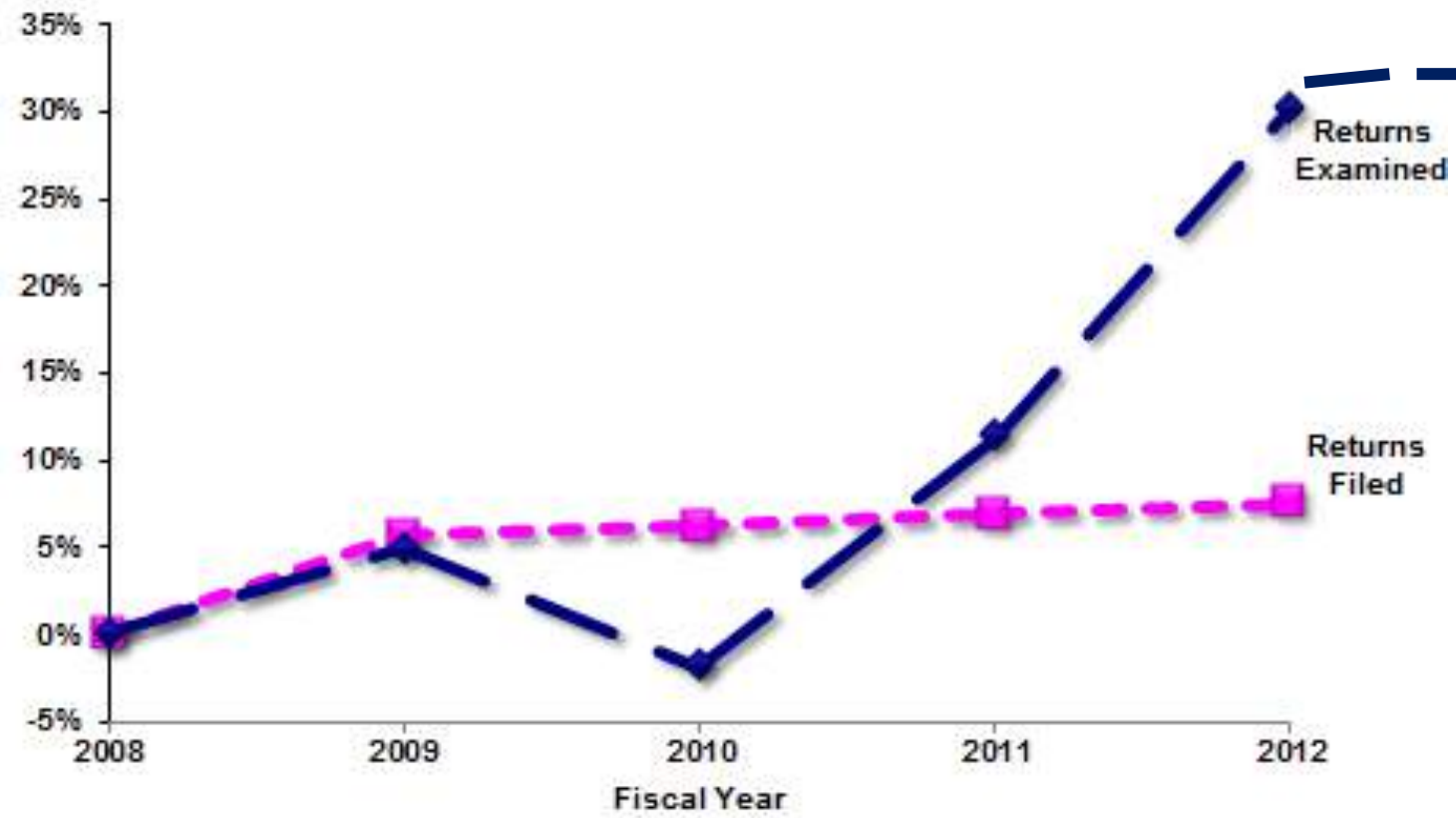
GAO December 2009

Actions Needed to Address Noncompliance with S Corporation Tax Rules

- GAO calculated that in the 2003 and 2004 tax years, the net shareholder compensation underreporting equaled roughly **\$23.6 billion**
- Further analyze the extent of noncompliance involving a long standing concern over inadequate shareholder compensation, and identify options for improving compliance (**PROBLEM**)
- Improve guidance to IRS examiners so that they might better target and determine adequate shareholder compensation (**TRAINING & TOOLS**)



Reasonable Compensation & the IRS





Reasonable Compensation & the IRS

The Latest News

- 2018: Austin, TX field office graduated 2,500 agents in October trained on Reasonable Compensation
- 2018: IRS agents changed their audit checklist and now must make sure **compensation is considered** in examinations of closely held S Corp's
- 2020 Established a National **Compliance Initiative Project [CIP]** to focus additional resources on the issue of Officer Compensation

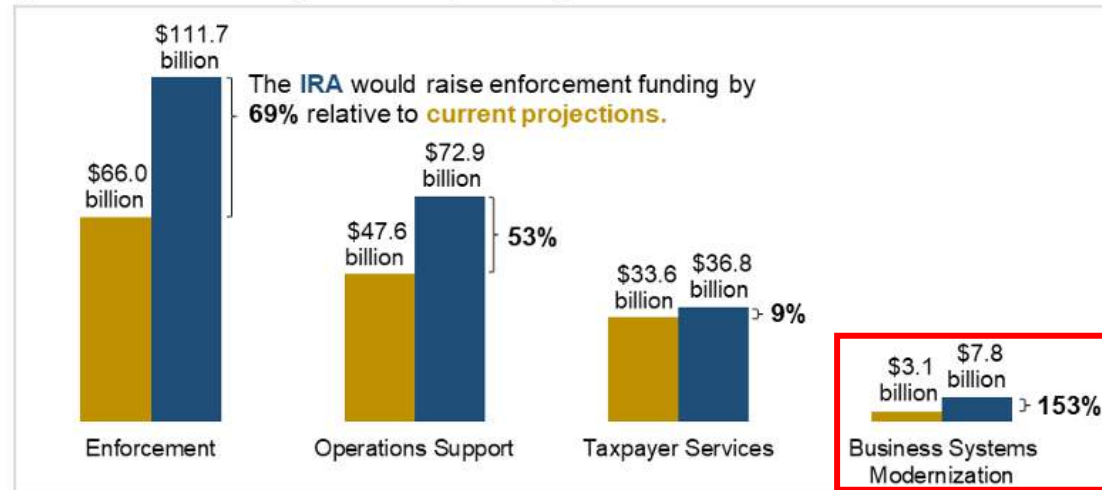


Reasonable Compensation & the IRS

Inflation Reduction Act of 2022 (IRA22)

- IRS Funding: \$80 Billion – \$45.6 Billion for Enforcement
- 87,000 new agents?
- **Massive Investment in Technologies that aid Investigations - \$4.7 Billion**

Figure 1. The IRS's Budget Authority Through FY2031 Under the Inflation Reduction Act



Source: Congressional Budget Office; Part 3 of Title I, Subtitle A of the Inflation Reduction Act.

Note: Assumes no change in base appropriations.



Reasonable Compensation & the IRS

2023 PayrollOrg* Congress

Identified reasonable compensation audits as an area the IRS will focus on in the immediate future.

SB/SE will be focusing on: Payroll Compliance [940 & 941]

- ERC Fraud Initiative: [56 hours of training]
- S Corp Audits: Assessing if S Corp owners receive RC
- Worker Classification Audits: 1099 v. W-2

*Formerly The American Payroll Association & Global Payroll Management Institute



Paul Mamo

Assistant Deputy Commissioner
for Services & Enforcement



Dan Lauer

Director of SB/SE,
Examinations and Specialty Tax



Reasonable Compensation & the IRS

Challenges are coming from multiple sources [BTW]

- Traditional 1120S Audits
- Compliance Initiative Projects
- Payroll / 1099 / 941 Audits*
- ERC Audits
- Lifestyle Audits*
- State Level

*Preparer Penalties



Reasonable Compensation & the IRS

Preparer Penalties \$5,000 IRC sec. 6694(b)

- IRS does expect preparers to have appropriate checklists
- IRS does not expect the preparer to merely accept the information
- IRS does require the preparer to be proactive
- Penalties can and will be imposed on preparers





Reasonable Compensation & the IRS

Burden of Proof IRC sec. 7491

- RC Challenged → the taxpayer has the “Burden of Proof”
- Burden of Proof shifts to the IRS if:
 - Taxpayer introduces Credible Evidence
 - Taxpayer has kept Records that meet IRS requirements

“We have provided RCReports to IRS auditors without issues or problems when asked as a checklist item on a small business audit.”

~Randy Tarpey, CPA





Reasonable Compensation & the IRS



Florida Challenge - A Specialty Workstream, Compensation Case Study





Reasonable Compensation & the IRS

Florida Challenge

- Nail Salon
- Booth Rentals Paid via 1099 
- 2019 Owner Comp \$40,500
- Challenged Owner Comp \$67,000
- Taxes; Penalties; Interest = \$10,000
- RCReports \$41,833
- No Change 



Reasonable Compensation & the IRS

No Tax Court for Reasonable Compensation 2017

Notice of Employment Tax Determination under IRC §7436 - Additional Compensation to Officer Employees

- Not Issue Letter 3523: Notice of Determination of Worker Classification
 - Cannot proceed to Tax Court
 - Pay Tax
 - Sue for refund

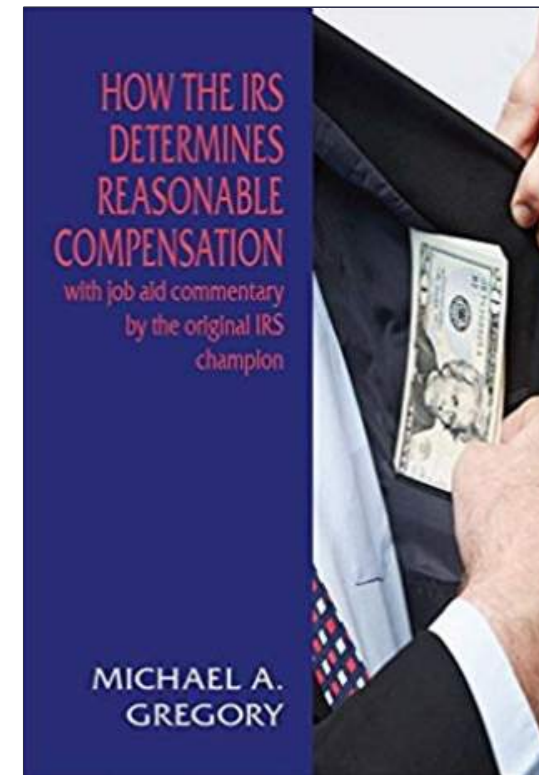




Determining Reasonable Compensation

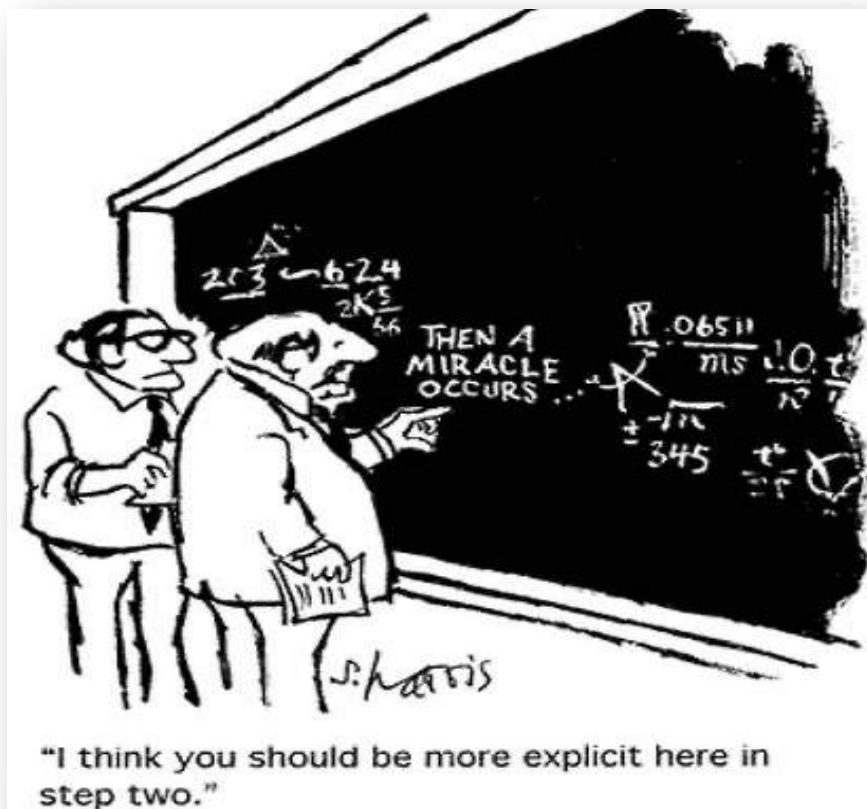
Reasonable Compensation Job Aid for IRS Valuation Professionals

- Companies have the burden of showing that compensation is reasonable
- Three Approaches
- Michael A. Gregory CVA, CBA, ASA





Determining Reasonable Compensation



Reasonable Compensation

Job Aid for IRS Valuation Professionals*

*(This Job Aid Can Also be Helpful to Revenue Agents and Other IRS Field Personnel)

October 29, 2014

How – Cost Approach

AKA Many Hats Approach



	D	E	F	G
Materials Cost Estimate Luis Cedillo per#6				
Size/Description	Quantity	Unit Cost	Cost	
Cubic yard	2.5	\$75.00	\$187.50	
#4 (1/2in. X 10ft)	20	\$4.47	\$89.40	
2in. x 4in. - 12ft	2	\$11.31	\$22.62	
2in. x 4in. - 16ft	2	\$14.95	\$29.90	
2in. x 4in. - 32 5/8in.	45	\$3.10	\$139.50	
2in. x 4in. - 8ft	16	\$3.06	\$48.96	
2in. x 4in. - 8ft	15	\$3.06	\$45.90	
2in. x 4in. - 8ft	8	\$3.06	\$24.48	
2in. x 6in. - 8ft	6	\$4.20	\$25.20	
1/2in. x 4ft x 8ft sheet	15	\$6.85	\$102.75	
8ft x 150ft	1	\$98.00	\$98.00	
ing Bundle of 200 sq. ft	3	\$300.00	\$900.00	
1/2in. x 4ft x 8ft sheet	15	\$6.85	\$102.75	
Gallon (400 sq. ft per gallon)				
2 coats	3	\$15.99	\$47.97	
3.5in. x 15in. - 40 sq. ft	3	\$8.48	\$25.44	
1/2in. 2 x 6in.	14	\$0.42	\$5.88	
24in. x 36in.	2	\$134.00	\$268.00	
Double - 7ft x 80in.	1	\$250.00	\$250.00	

How – Cost Approach

- All Tasks Performed
- Apportion Time
- Skill-Proficiency
- Comparability Data
- Small Business



"The consultant said I was wearing too many hats."



Scott Stone at 25

How many hours do you work per week on average? 40+				
State your business is located Illinois				
County or township your business is located Cook				
Yes/No	Title	Definition	Time %	Proficiency
X	Sales Representatives	Sell goods or services for wholesalers or manufacturers to businesses or groups of individuals. Work requires substantial knowledge of items sold.	10%	Below Average
X	Bookkeeper	Compute, classify, and record numerical data to keep financial records complete. Perform any combination of routine calculating, posting, and verifying duties to obtain primary financial data for use in maintaining accounting records. May also check the accuracy of figures, calculations, and postings pertaining to business transactions recorded by other workers.	10%	Below Average
X	Purchasing Clerk	Compile information and records to draw up purchase orders for procurement of materials and services.	5%	Average
X	Business Office Manager	Plan, direct, or coordinate one or more administrative services of an organization, such as records and information management, mail distribution, facilities planning and maintenance, custodial operations, and other office support services.	15%	Average
Please list any specialized tasks which fall outside the common tasks that you've already selected from. You may add as many specialized tasks as you need to adequately account for all the other tasks you perform for your business regularly throughout the year and then rate your skill level for each task added. (Example: Veterinarian; Hair Stylist; Pastry Chef; Etc...)				
Title	Description	Time %	Proficiency	
Concrete Finisher	Smooth and finish surfaces of poured concrete, such as floors, walks, sidewalks, roads, or curbs using a variety of hand and power tools. Align forms for sidewalks, curbs, or gutters; patch voids; and use saws to cut expansion joints.	30%	Above Average	
Maintenance Mechanic	Perform work involving the skills of two or more maintenance or craft occupations to keep machines, mechanical equipment, or the structure of an establishment in repair. Duties may involve pipe fitting; boiler making; insulating; welding; machining; carpentry; repairing electrical or mechanical equipment; installing, aligning, and balancing new equipment; and repairing buildings, floors, or stairs.	30%	Above Average	
		100%	TOTAL	





Scott Stone at 25



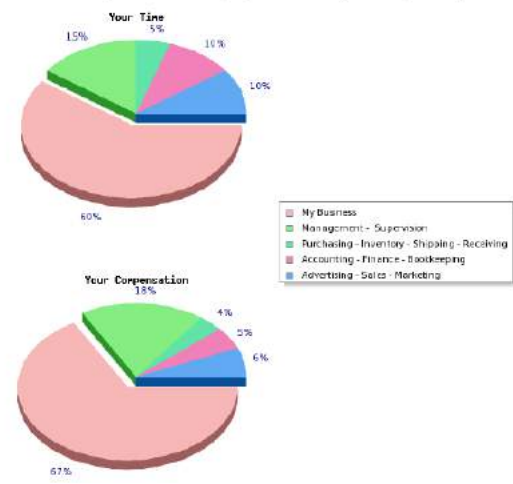
Report for Scott Stone of Stone Concrete, Inc.

Your estimated annual Reasonable Compensation: \$68,788

Thank you for entrusting Sam Miller of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your S Corporation based on your responsibilities and the duties that you perform annually. Reasonable Compensation is defined by the IRS as "The value that would ordinarily be paid for like services by like enterprises under like circumstances."

The calculated salary of \$68,788 was determined to be reasonable compensation based on the type of work performed, the skill level of the work performed and the number of hours the work is performed annually. You told us that you work 2600 hours per year in Cook County, IL. Our analysis indicates the annual salary of \$68,788 would be a reasonable cost to hire employee(s) to perform the duties and responsibilities that you currently perform.

Potomac Tax and Valuation, PC recommends completing a reasonable compensation report annually.



Report for Scott Stone of Stone Concrete, Inc.

Advertising - Sales - Marketing 10% of your time 208 hours per year 6.4% of your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Sales Representatives	Below Avg.	100%	10%	208.0	\$ 21.18	\$ 4,405

Accounting - Finance - Bookkeeping 10% of your time 208 hours per year 4.89% of your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Bookkeeper	Below Avg.	100%	10%	208.0	\$ 16.16	\$ 3,361

Purchasing - Inventory - Shipping - Receiving 5% of your time 104 hours per year 3.57% of your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Purchasing Clerk	Average	100%	5%	104.0	\$ 23.61	\$ 2,455

Management - Supervision 15% of your time 312 hours per year 18.26% of your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Business Office Manager	Average	100%	15%	312.0	\$ 40.33	\$ 12,593

My Business 60% of your time 1,248 hours per year 66.85% of your comp.

Task	Proficiency	Category	Overall	Hours	Wage	Annual
Concrete Finisher	Above Avg.	50%	30%	624.0	\$ 45.21	\$ 28,211
Maintenance Mechanic	Above Avg.	50%	30%	624.0	\$ 28.48	\$ 17,772



How many hours do you work per week on average? 40+

State your business is located Illinois

County or township your business is located Cook

Yes/No	Title	Definition	Time %	Proficiency
X	Sales Representatives	Sell goods or services for wholesalers or manufacturers to businesses or groups of individuals. Work requires substantial knowledge of items sold.	10%	Below Average
X	Bookkeeper	Compute, classify, and record numerical data to keep financial records complete. Perform any combination of routine calculating, posting, and verifying duties to obtain primary financial data for use in maintaining accounting records. May also check the accuracy of figures, calculations, and postings pertaining to business transactions recorded by other workers.	10%	Below Average
X	Purchasing Clerk	Compile information and records to draw up purchase orders for procurement of materials and services.	5%	Average
X	Business Office Manager	Plan, direct, or coordinate one or more administrative services of an organization, such as records and information management, mail distribution, facilities planning and maintenance, custodial operations, and other office support services.	15%	Average

Please list any specialized tasks which fall outside the common tasks that you've already selected from. You may add as many specialized tasks as you need to adequately account for all the other tasks you perform for your business regularly throughout the year and then rate your skill level for each task added. (Example: Veterinarian; Hair Stylist; Pastry Chef; Etc...)

Title	Description	Time %	Proficiency
Concrete Finisher	Smooth and finish surfaces of poured concrete, such as floors, walks, sidewalks, roads, or curbs using a variety of hand and power tools. Align forms for sidewalks, curbs, or gutters; patch voids; and use saws to cut expansion joints.	30%	Above Average
Maint-enance Mechanic	Perform work involving the skills of two or more maintenance or craft occupations to keep machines, mechanical equipment, or the structure of an establishment in repair. Duties may involve pipe fitting; boiler making; insulating; welding; machining; carpentry; repairing electrical or mechanical equipment; installing, aligning, and balancing new equipment; and repairing buildings, floors, or stairs.	30%	Above Average
		100%	TOTAL

How – Market Approach

AKA Industry Comparison Approach





How – Market Approach

- Size
- Industry
- Management
- Comparability Data
- Medium Business

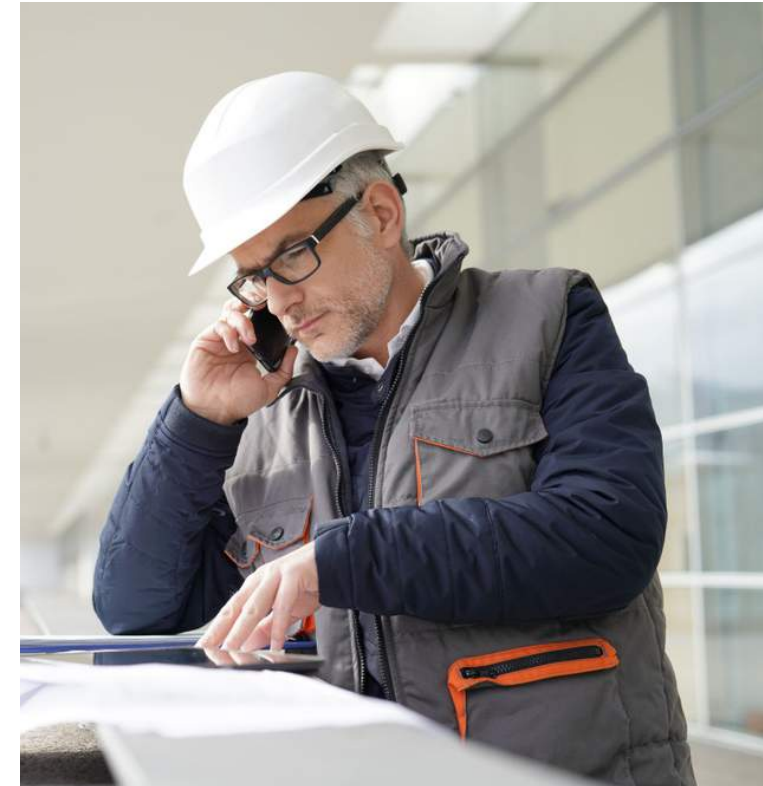




Scott Stone at 45

In order to help us build your Reasonable Compensation profile, tell us a little more about yourself and your business:

Industry	Specialty trade contractors
Occupation	CEO
State	Illinois
Metro area	Chicago
Number of employees	35
Adjusted Gross Profit	3.5 Million
Business performance versus peers	Above average
Owner experience versus peers	High
Hours worked per week on average	55





Scott Stone at 45



Report for Scott Stone of Stone Concrete, Inc.

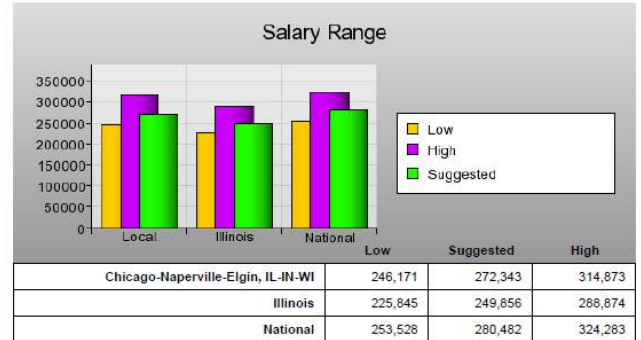
Report for Scott Stone of Stone Concrete, Inc.

Your estimated annual Reasonable Compensation: \$272,343

Thank you for entrusting Sam Miller of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your S Corporation based on your responsibilities and the duties that you perform annually. Reasonable Compensation is defined by the IRS as "The value that would ordinarily be paid for like services by like enterprises under like circumstances".

Your suggested salary range: \$225,845 to \$314,873 with a suggested salary of \$272,343 was determined to be Reasonable Compensation based on your role in the company, industry, size of the business, time devoted to the business, your experience and location. Any wage selected within the suggested range or expanded geographical area(s) is acceptable and within a 95% confidence interval.

Potomac Tax and Valuation, PC recommends completing a Reasonable Compensation report annually.



Business Summary:

Calculated for: Scott Stone
 Company: Stone Concrete, Inc.
 Interview completed: 20XX-05-11 17:50:57
 Report calendar year: 20XX
 NAICS industry: 238000 - Specialty Trade Contractors
 MSA Location: Chicago-Naperville-Elgin, IL-IN-WI
 State: Illinois
 Occupation: Chief Executives - Determine and formulate policies and provide overall direction of companies or private and public sector organizations within guidelines set up by a board of directors or similar governing body. Plan, direct, or coordinate operational activities at the highest level of management with the help of subordinate executives and staff managers.
 Number of Employees (FTE): 25-75
 Gross Revenue: 5m-10m
 Business Performance vs. Peers: Above Average
 Owner Experience and/or Proficiency Level: High
 Time Dedicated to the Business: Workaholic (65+ hr/week)



In order to help us build your Reasonable Compensation profile, tell us a little more about yourself and your business:

Industry	Specialty trade contractors
Occupation	CEO
State	Illinois
Metro area	Chicago
Number of employees	35
Adjusted Gross Profit	3.5 Million
Business performance versus peers	Above average
Owner experience versus peers	High
Hours worked per week on average	55



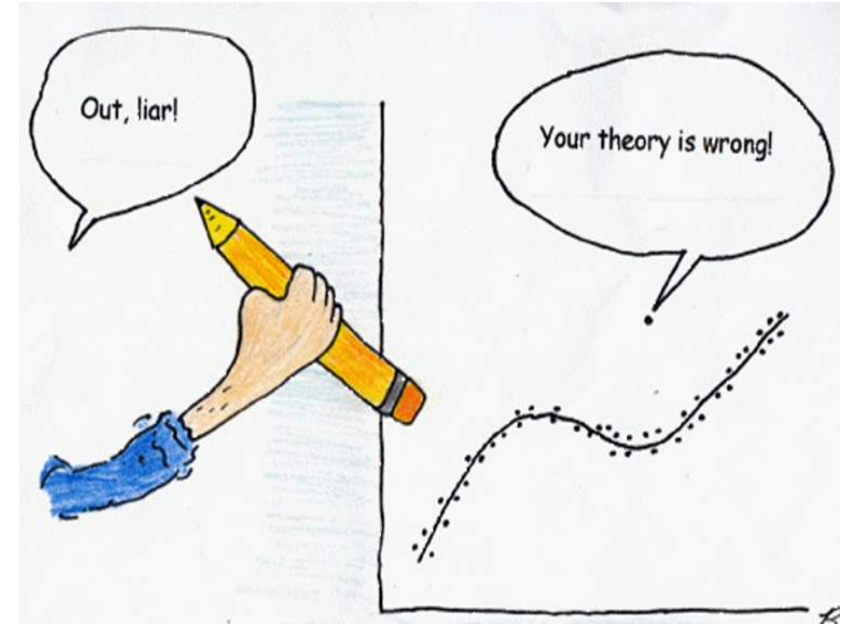
How – Income Approach

AKA Independent Investors Test



How – Income Approach

- No Comparable Wage Data
- ROI v. Reasonable Compensation
- Outliers
- 2nd Opinion/Test





Scott Stone at 55

In order to help us build your Reasonable Compensation profile, tell us a little more about yourself and your business:

Estimated FMV beginning of the year	6,000,000
Estimated increase in FMV by year end	1,750,000
Target return (independent investor rate)	20%





Scott Stone at 55



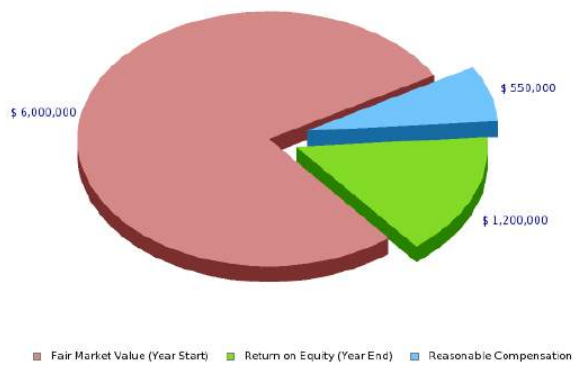
Report for Scott Stone of Stone Technologies, Inc.

Your estimated annual Reasonable Compensation: \$550,000

Thank you for entrusting Sam Miller of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your C Corporation based on your responsibilities and the duties that you perform annually. Reasonable Compensation is defined by the IRS as "The value that would ordinarily be paid for like services by like enterprises under like circumstances."

The calculated salary of \$550,000 was determined to be Reasonable Compensation based on the increase in the Fair Market Value of your company over a one year time frame and a Return on Investment of 20.00% in conjunction with your efforts.

Potomac Tax and Valuation, PC recommends completing a Reasonable Compensation report annually.



Report for Scott Stone of Stone Technologies, Inc.

How was my "Annual Salary" or "Reasonable Compensation" calculated?

Potomac Tax and Valuation, PC relies on the IRS formula for determining Reasonable Compensation using the Income Approach (aka The Independent Investors Test) as outlined in the IRS Job Aid: Reasonable Compensation for IRS Valuation Professionals.

This report determines Reasonable Compensation based on the increase in Fair Market Value (FMV) of the business over a one year time frame and a target rate of return. The owner's Reasonable Compensation is computed based on the following formulas:

$$\text{Increase in FMV over the year before Reasonable Compensation} - (\text{Target Return} \times \text{FMV at the beginning of the year}) = \text{Reasonable Compensation}$$

Your Reasonable Compensation figure includes taxable Medicare wages & bonuses, healthcare and flexible spending accounts (FSA). It does not include non-taxable fringe benefits such as vehicle or vehicle allowance, stock options, company loans and other items not reported on a W-2 as taxable compensation.

Your actual replacement salary could vary considerably from our estimate, especially if the FMV estimates differ substantially from actual figures.

Methodology

This report uses the Income Approach to determine a Reasonable Compensation figure. The Income Approach determines whether a hypothetical investor would be satisfied with their return on investment when looking at the financial performance of the business in conjunction with the compensation level of the owner.

The income approach can only be correctly applied when the Fair Market Value (FMV) of the company is available for each year that compensation is being examined.

The rationale behind the Independent investor Test is that investors pay employees to increase the value of the assets entrusted to their management. A high rate of return indicates that the assets' value increased and that the employee provided valuable services. Thus, if investors obtain returns above what they should reasonably expect, an employee's salary is presumptively reasonable.

The Income approach generally works best when there is no comparability data available.

For more information on Methodologies:

- [Job Aid for IRS Valuation Professionals](#)
- Reasonable Compensation Reports, Inc. Methodology Report (available upon request)



In order to help us build your Reasonable Compensation profile, tell us a little more about yourself and your business:

Estimated FMV beginning of the year	6,000,000
Estimated increase in FMV by year end	1,750,000
Target return (independent investor rate)	20%



Who We Are

RCReports Overview

- Closely-held Business Owners
- Tool for CPAs, EA's, Tax & Financial Advisors
- IRS Criteria & Guidelines
- Court Precedents
- Independent Unbiased Reasonable Compensation Figure
- Defensible IRS Examination
- Defendable – Court



POTOMAC
Tax & Valuation

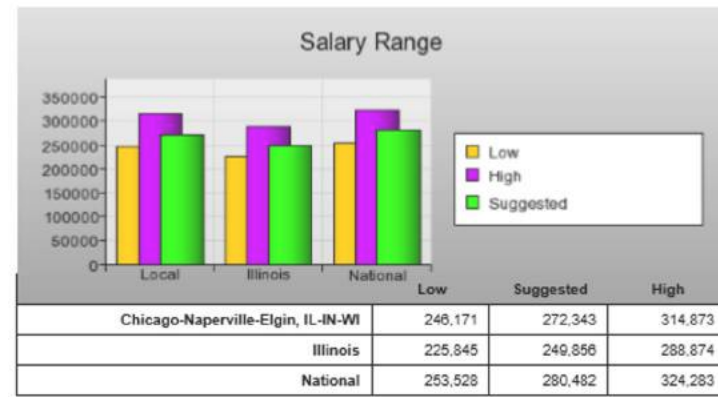
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Potomac Tax and Valuation, PC recommends completing a Reasonable Compensation report annually.





Who We Are

Key RCReports Features

- Results available immediately
- 30 Day edit period
- One Account – Multiple Users
- RCReports exclusive data base of wage
- Over 850 Occupational Profiles
- “We have provided RCReports to IRS auditors without issues or problems when asked as a checklist item on a small business audit.” ~Randy Tarpey, CPA



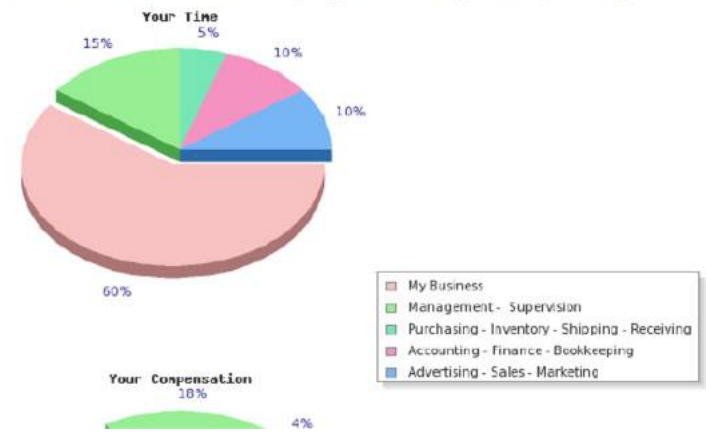
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Report for Scott Stone of Stone Concrete, Inc.

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Potomac Tax and Valuation, PC recommends completing a reasonable compensation report annually.





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Run 1 Report	Unlimited Reports	Unlimited Reports
Access for 30 Days	Includes 2 users	Includes 3 users

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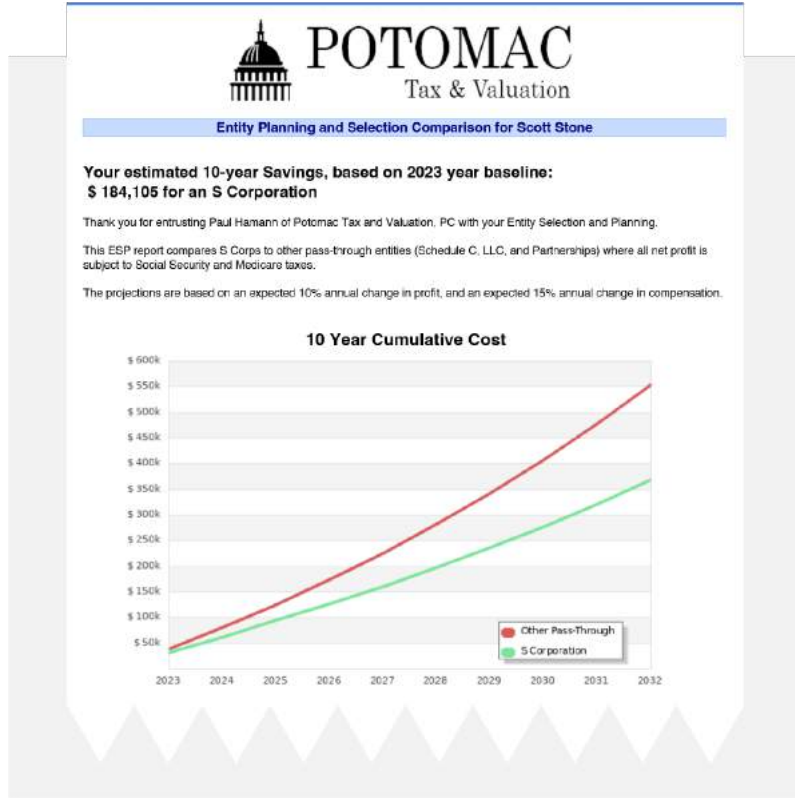
RC Reports



Advice from RCReports

- Send Issue Letter
- Stress Test
- Entity Selection/Planning

“ The first with a fact-based figure wins



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Thank you!

Paul Hamann

Founder & President, RCReports

paul@RCReports.com

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Learn More?



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30 Min Demo

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