

## Litigation Issues With Regard to Compensation

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One of the issues that often arises in a litigation context is that of reasonable compensation. The issues related to reasonable compensation fall into problematic discussions in one of two areas:

1. Discussions with the Internal Revenue Service with regard to the deductibility of compensation as “ordinary and necessary”  
  
and
2. Discussions with regard to shareholders and or boards of directors with regard to reasonable compensation

Generally, the issues for both of the two antagonists would fall into the same general thought patterns. If a corporate entity is taking a deduction for compensation, that compensation needs to be reasonable based on the particular circumstances. Reasonable compensation will ordinarily be subject to outside scrutiny.

In valuing a business, one of the “normalization” adjustments that may be related to the income statement would include one with regard to owner’s compensation. “Owner’s Compensation – the owners of closely held companies - can generally set their salaries and other perks at whatever level they want. If such compensation packages are above or below industry norms, an adjustment should be made”<sup>1</sup>. This can come into play in the general valuation of a business as well as with regard to the deductibility of compensation for tax or other purposes. Many shareholder derivative suits will include a charge that unreasonable compensation has been taken by a controlling shareholder to the detriment of a minority shareholder.

In ascertaining whether or not the compensation that has been paid historically is “reasonable”, outside sources would usually need to be consulted. In addition, it will be important to fully understand the job description(s) of the key employees/owners. Generally, the information that will need to be compiled with regard to the job description will include

- The industry
- The size of the company
- The complexity of the job(s) being held
- Any outside research that has been done to establish salary or bonus policies

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<sup>1</sup> Practitioners Publishing Company “Guide to Litigation Support Services” paragraph 1003.43(a).

- Any board minutes or resolutions with regard to the setting of salaries and or bonuses
- Comparable information with regard to both public and private companies in similar industries and sizes
- Independent research that may be done in connection with the subject litigation or that which may be done to attempt to avoid litigation.

In dealing with the Internal Revenue Service in the case of a “C” corporation (in an S corporation, there's usually no need to document reasonable compensation as the difference flows to the shareholders and is taxable in any event) the ability to show the relative complexity of the jobs being held by the officer/owners will normally be a key component to prevailing. The ideal time to perform the requisite research is before the compensation is determined and paid. If the requisite research was not done on a timely basis and or is not available at the time of the Internal Revenue Service inquiry, it may need to be recreated or done from scratch.

In the case of a shareholder suit or shareholder derivative suit, it is also preferable for the officer/owners and or the board of directors to make the requisite inquiries at the time the determination is being made with regard to compensation. Like the circumstances with the IRS above, if an inquiry is being made from an outside source, and the original research either was not done or is not available, additional research may be required at the time of the threatened or actual litigation. Industry resources will often be available as will general compensation information from the Department of Labor, industry sources and outside consultants. (See sidebar article)

The ability to prevail in a circumstance where reasonable compensation is being questioned will invariably be determined by the depth of the research, the complete description of the job description or descriptions of the individuals involved and the ability to convince the Internal Revenue Service, the shareholder bringing the suit or the trier of the facts if it goes to court of the appropriate level of compensation having been paid.

One of the issues that often comes up is individuals in closely held businesses who are providing services that are equivalent to more than one position. The president of a company may also be acting as CEO, COO, Chief Engineer, Inventor, Chief Marketing Officer, Chief Financial Officer and or other roles. The individual may be working 50, 60, 70 or 80 hours a week on a regular basis. The individual involved may in fact have “contributed” intellectual resources for which due compensation is not separately being paid. Each of these areas needs to be investigated, documented and the fair and reasonable compensation for each of these roles needs to be determined. In general, it may be appropriate to utilize a sum of the appropriate compensation values for multiple roles, sometimes reduced partially due to the need of the company to hire additional assistance to provide some portion of the responsibility normally given to that individual.

In summation, preparation and research are the keys to determining an appropriate level of compensation and the same issues will generally determine who prevails if the issue is brought into a dispute.