

CHECKLIST C302

Factors Indicating Employee-shareholder Reasonable Compensation

Name/ID: _____ Year: _____

Preparer's Initials and Date: _____ Reviewer's Initials and Date: _____

Items 1 through 4 should be answered affirmatively in order to deduct compensation.

	Yes	No	N/A
1. Is the compensation an ordinary and necessary business expense? ^a	_____	_____	_____
2. Was the compensation paid or incurred during the tax year? ^a	_____	_____	_____
3. Is the compensation for the rendering of personal services? ^b	_____	_____	_____
4. Is the compensation reasonable? ^b (A determination of reasonableness is generally based on all facts and circumstances. This list is provided to remind the practitioner of some factors that have been accepted by the courts as indications of the reasonableness of compensation paid to shareholder/employees. ^c This list is not all-inclusive; the courts and the IRS might consider other factors in determining whether compensation is reasonable. Not all questions must be answered affirmatively for the compensation to be considered reasonable. The practitioner should include in the files with this checklist all documentation available to support the answers given.)	_____	_____	_____
a. Character and Condition of Corporation:			
(1) Are financial ratios favorable?	_____	_____	_____
(2) Are sales and profits stable or growing?	_____	_____	_____
(3) Does the company prosper in a highly competitive industry?	_____	_____	_____
(4) Does the company prosper in poor economic or industry conditions?	_____	_____	_____
(5) Is the business complex or highly specialized?	_____	_____	_____
(6) Have significant investments been made in company assets during the year(s) in question?	_____	_____	_____
(7) Would an inactive, independent investor be satisfied with the company's performance based on the above factors?	_____	_____	_____
b. Roles of Shareholder/Employees in Corporation:			
(1) Do they possess unique technical, marketing, or innovation skills, etc. that would be difficult to replace?	_____	_____	_____
(2) Have they made identifiable contributions to the success of the company?	_____	_____	_____
(3) Would the business flounder without them?	_____	_____	_____
(4) Do they have heavy experience in the industry?	_____	_____	_____
(5) Do they work long hours and have heavy workloads?	_____	_____	_____
(6) Do they have high levels of education or specialized training?	_____	_____	_____
(7) Do they handle diverse aspects of the business?	_____	_____	_____
(8) Do they have excellent decision-making and strategic planning skills?	_____	_____	_____
(9) Do they have long lengths of service which demonstrate loyalty and commitment?	_____	_____	_____

	Yes	No	N/A
(10) Do they operate with low levels of staff support?	_____	_____	_____
(11) Do they have low levels of other fringe benefits?	_____	_____	_____
(12) Do they specialize in complex projects for the corporation?	_____	_____	_____
(13) Do they have a professional reputation outside of the corporation?	_____	_____	_____
c. Internal Consistency in Establishing Compensation Levels (Internal Comparison):			
(1) Does the company have a compensation policy that can be documented and has been followed consistently over the years?	_____	_____	_____
(2) Are there some similarities to how compensation or bonuses of other employees are determined?	_____	_____	_____
(3) Is compensation clearly related to company results and not just enough to "zero out" taxable income?	_____	_____	_____
(4) Was it the corporation's intent to pay compensation? ^d	_____	_____	_____
d. Comparative Compensation Levels for Other Businesses (External Comparison):			
(1) Are compensation levels reasonable in comparison to what employees of similar businesses receive for like duties?	_____	_____	_____
(2) Does the shareholder/employee in effect perform the duties of several positions (CFO, marketing director, personnel manager, etc.) for one salary?	_____	_____	_____
(3) Is the business itself or the role of the individual so unique that comparisons with other companies are difficult or impossible?	_____	_____	_____
(4) Are the quality and/or quantity of services provided by the shareholder/employee clearly exceptional—as evidenced by the performance of the company as a whole?	_____	_____	_____
e. Conflicts of Interest in Setting Compensation Levels:			
(1) Is it clear that compensation levels are not simply tied to stock ownership?	_____	_____	_____
(2) Have dividends been paid in the years in question (although the absence of dividends is not in itself evidence of excessive compensation)?	_____	_____	_____
(3) If dividends alone do not provide a significant return on investment, would an outside investor be satisfied with the return on equity or growth in value of the company?	_____	_____	_____
f. Other:			
(1) If the current compensation includes payments for services rendered in past years, was the employee underpaid in those years? ^e	_____	_____	_____
(2) If a payback agreement was in existence, was it executed for reasons other than a perception that compensation was unreasonable? ^f	_____	_____	_____

Notes:

^a IRC Sec. 162(a).

^b IRC Sec. 162(a)(1).

- ^c *Dexsil Corp.*, 147 F.3d 96, 81 AFTR 2d 98-2312 (2nd Cir. 1998); *Rapco, Inc.*, TC Memo 1995-128 (1995), *aff'd* 77 AFTR 2d 96-2405; *Elliotts, Inc.*, 716 F.2d 1241, 52 AFTR 2d 83-5976 (9th Cir. 1983); *Mortex Mfg. Co.*, TC Memo 1994-110 (1994).
- ^d *Menard, Inc.*, 103 AFTR 2d 2009-1280 (7th Cir. 2009), *rev'g* TC Memo 2004-207 (2004) and TC Memo 2005-003 (2005).
- ^e *Acme Construction Co., Inc.*, TC Memo 1995-6 (1995); *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115, 8 AFTR 10901 (1930).
- ^f *Charles Schneider & Co.*, 500 F.2d 148, 34 AFTR 2d 74-5422 (8th Cir. 1974), *cert. den* 420 U.S. 908 (1975); *Saja Electric, Inc.*, TC Memo 1974-290 (1974), *aff'd* 536 F.2d 388 (5th Cir. 1976), *cert. den.* 429 U.S. 979 (1976).