AGH CPAs & ADVISORS

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ALERT: Put measures in place to defend reasonable executive compensation as IRS increases scrutiny

Compensation for executives in S corporations, closely held C corporations and not-for-profit organizations is receiving increased IRS attention. If compensation in these types of entities is judged to be too high or too low in an IRS exam, additional taxes and penalties may be incurred for the corporation, the executive, and even the board of directors. Following are hot-button executive compensation issues for each of the three entity types.

S corporations (S corps)
An IRS exam will evaluate whether S corps pay executives "reasonable compensation" (S corps are more likely to err on the low than the high side). If the IRS determines compensation is not comparable to others with similar titles in the market, the S corp could face not only a required pay adjustment and payroll tax penalties, but a corresponding change in shareholder distributions.

C corporations (C corps)
If C corp compensation to shareholder-employees is higher than market, it could be seen as a "disguised dividend." Establishing written compensation criteria, tying compensation to company performance or goals, and outlining the calculation method for bonuses and compensation can help mitigate the appearance of "excessive" compensation for shareholders.

Another risky issue for C corps arises when top executives, approaching retirement, may begin to reduce work hours or responsibilities. A corresponding pay adjustment should be considered to keep pay in line with performance of duties.

Not-for-profit organizations
Similar to C corps, not-for-profits should consider ways to ensure executive compensation is in line with the market. Any loans to executives and even reimbursement for expenses should be appropriately documented and carried out according to a written policy. If executive pay is "excessive" and was approved by board members or managers in the organization, excise taxes could be imposed on not only the executive, but as a personal liability for the board members or managers who approved it.

All entity types
Loans to employees or shareholders may also draw IRS attention. If the entity makes a loan to a shareholder or employee, creating a written document with specific repayment terms and reasonable interest rates on the loan can help offset concern that the loan may be additional compensation or a taxable distribution.

Summary
The combination of a written compensation plan, reviewed for market comparability and implemented, along with careful documentation of any loans or other financial benefits provided to executives is good practice for any organization. For C corps, S corps and not-for-profit organizations, this practice is an essential defense in case of an IRS exam.

For more information about executive compensation issues, contact your AGH tax professional, AGH senior vice president of tax services Shawn Sullivan (shawn.sullivan@aghlc.com or 316-291-4110), or AGH Employer Solutions organizational consultant Carrie Wiegand, PHR (carrie.wiegand@aghlc.com or 316-291-4022).

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