

IMPORTANT PLANNING OPPORTUNITIES WHEN CLAIMING A COMPENSATION DEDUCTION ON YOUR CLIENT'S TAX RETURN

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By now you are probably familiar with the changes made to the New Hampshire Business Profits Tax (the "BPT") in 2010 which affect a business owner's deduction for the fair and reasonable compensation for personal services rendered to the business. See [RSA 77-A:4, III](#). If not, take a quick look at our previous article, "[A Step in the Right Direction: Changes to the New Hampshire Reasonable Compensation Deduction](#)" (August 4, 2010), for a brief rundown of the major provisions. Among these changes is a new required allocation schedule, [NH-BPT-RCD](#), the substance of which we discussed in "[New Hampshire Department of Revenue Administration to Issue New Reasonable Compensation Deduction Schedule](#)" (November 29, 2010). The focus of this article will be on how to provide the most value to clients *this year* when completing the new NH-BPT-RCD Schedule or preparing a corporate tax return for a Subchapter S entity, by getting them to start thinking about *next year*.

For the first time, businesses will need to specify the total compensation deduction claimed for the tax period and the allocation of the deduction among its owners on a separate schedule, NH-BPT-RCD, for unincorporated business organizations. As a reminder, in this "bridge year" neither the old \$6,000 minimum deduction allowance per partner or member nor the new \$50,000 record-keeping safe harbor is available. Accordingly, the New Hampshire Department of Revenue Administration ("DRA") is technically free to challenge the reasonableness of any amount of proprietor, partner or member compensation claimed as a deduction. As in past years, unincorporated business owners who had a profitable year may find themselves in the unenviable position of defending the reasonableness of their compensation deduction against a DRA audit and attempting to provide *ex post facto* justification for compensation levels. Discussing this unfortunate possibility

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with clients provides the perfect opportunity to explain the reasonable compensation axiom that when it comes to supporting compensation, the best defense is a good offense.

For those who have been involved in a DRA reasonable compensation audit, whether of an incorporated or unincorporated business, it is understood that justifying compensation levels is much more difficult when the only supporting documentation available is from the end of the tax year when the owner already has a clear snapshot of how the business performed, or even worse, from the time the Audit letter was issued to the client. This is primarily because the first major component of a reasonable compensation analysis is “intent.” The “intent” component focuses on whether payments to an owner were in fact intended to be made for services rendered. When contemporaneous documentation exists establishing that an owner’s compensation methodology was fixed at the beginning of the year, before profits were known, it becomes more difficult for the DRA to assert that payments were not intended to be compensation but rather a mere distribution of the profits to the owners. In contrast, when there is no compensation arrangement documented and it appears that the owner simply “comp’d out” or left only a minimal amount of profit in the business at the end of the year, the DRA has a much stronger argument that the business owner is just trying to take profits out of the business and such payments were not truly intended as compensation. As practitioners, you must also keep in mind that the statutory language now indicates that the compensation deduction is not intended as a deduction for “...amounts that are attributable to an owner’s return on investment of capital”.

A good offense involves both compensation planning and appropriate documentation. Many clients avoid documenting compensation arrangements out of fear that it may hamstring the business if projections are off. With proper planning and drafting, this should not be an issue. Compensation may be documented by an employment agreement containing a customized combination of benefits, salary, wages, commissions and incentive-based pay. The particular combination appropriate for a client will depend on many factors, such as past financial performance of the business, the nature of the business, ongoing or upcoming projects or expenditures, future projections and cash flow needs. Additionally, any incentive-based compensation component should involve pre-established performance goals and a methodology for computing compensation in some objective manner. Approval of an owner’s compensation arrangements should be documented in the minutes or written consent resolutions of the business as early as possible during the tax year, and any incentive-based compensation should again be documented and approved in the minutes or consents when objectives are reviewed and the payment amount is computed.

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Compensation arrangements should also thoroughly describe the significant services required to be performed by the owner and should articulate some of the unique skills and qualifications of the owner which bear on his or her appropriate compensation level. This will help satisfy the second major component of reasonable compensation analysis, that the amount of compensation be reasonable in comparison with the services performed, which is most often the battleground between business owners and the DRA. A well-drafted employment agreement containing a thorough description of the services to be performed by the owner is likely more credible than the same description given only as a defensive measure in response to a reasonable compensation audit. Being proactive with compensation planning will not necessarily avoid an audit, but it will provide a much stronger offense should an audit arise.

For those clients you typically only see once a year during tax season, completing NH-BPT-RCD or the corporate tax return provides the perfect opportunity to mention compensation planning. It may be best to set up an appointment for the client to come back after tax season to discuss documenting compensation arrangements in a manner that will provide the client with some level of protection should a reasonable compensation issue ever arise in the future. The tax practitioner should explain that by failing to proactively engage in compensation planning, a business owner incurs the risk that he or she will have a profitable year and will be put on the defensive by a DRA audit with only end-of-year hindsight analysis to support the reasonableness of compensation.

Another reason to ensure there is proper support for any compensation deduction taken is that tax practitioners are now required to sign the new reasonable compensation deduction schedule under penalties of perjury along with the taxpayer. The tax practitioner must attest that to the best of his or her belief, the information provided is true, correct and complete. If there is little to no documentation to support compensation, the practitioner may be in the precarious situation of being required to swear to something of which he or she has very little knowledge or supporting evidence. Failure to sign the schedule could result in the entire return being deemed incomplete and thus not timely filed. [See N.H. T.I.R. 2010-011](#) and [2010-012](#). If deemed not to have been timely filed, penalties may accrue and the statute of limitations period does not begin to run. [See RSA § 21-J:29](#), [RSA § 21-J:31](#).

Small steps taken now to document compensation arrangements may mean a big advantage down the road should the DRA ever challenge the reasonableness of a business owner's compensation. Raising compensation planning as an issue with clients when completing the NH-BPT-RCD Schedule or the corporate tax return will remind business owners of the reasonable compensation issue

and provide them an opportunity to take proactive measures to protect against an audit. Should you have any questions regarding compensation planning and its usefulness in the context of a reasonable compensation audit, please feel free to contact any member of Devine Millimet's Tax Practice Group.

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