

TAX UPDATE - RECORDS SUBSTANTIATING REASONABLE COMPENSATION DEDUCTION

By: *Maurice P. Gilbert, CPA, MST*
Director of State Taxation
Email: mgilbert@devinemillimet.com
Phone: 603.695.8612

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The Legislature amended the reasonable compensation deduction under the Business Profits Tax ("BPT") effective for taxable periods beginning on or after January 1, 2011. *Chapter 207, Laws of 2011*. The language of RSA 77-A:4, III(b) now contains the following requirement:

"...The business organization *shall keep such records* as may be necessary to determine that the deduction *is reasonable under these standards*." Emphasis Added

The standards referred to in the sentence are contained in Section 162(a)(1) of the Internal Revenue Code, as amended, the Treasury Regulations, administrative rulings issued by the Internal Revenue Service and judicial cases relating to compensation. In addition, the Legislature modified the provision of RSA 77-A:11 in the following manner:

"Each business organization shall:

Keep such records as may be necessary to determine the amount of its liability under this chapter *and to determine whether the compensation claimed as a deduction under RSA 77-A:4, III is reasonable*." Emphasis Added

It is clear from these statutory changes to the BPT that business organizations will be required to maintain supporting documentation for any compensation deduction taken for proprietors, partners and members of limited liability companies that is greater than the recordkeeping safe-harbor contained in RSA 77-A:4, III (c). Failure to maintain supporting documentation could result in a complete disallowance of the deduction rather than a disagreement about its reasonableness.

Tax Practice Group *Federal, State & Local*

**Jon Sparkman, Esq., CPA,
Chair**
603.695.8507
jsparkman@devinemillimet.com

Steven Cohen, Esq., CPA, LLM
603.695.8504
scohen@devinemillimet.com

Alexander J. Walker, Esq.
603.695.8553
awalker@devinemillimet.com

**Maurice P. Gilbert, CPA, MST
Director of State Taxation**
603.695.8612
mgilbert@devinemillimet.com

Anu R. Mullikin, Esq., LLM
603.695.8536
amullikin@devinemillimet.com

Daniel Will, Esq.
603.695.8554
dwill@devinemillimet.com

Patricia M. McGrath, Esq., LLM
603.695.8537
pmcgrath@devinemillimet.com

Jason E. Cole, Esq., CPA
603.695.8566
jcole@devinemillimet.com

Harper R. Marshall, Esq.
603.695.8645
hmarshall@devinemillimet.com

Justin T. Vartanian, Esq.
603.695.8635
jvartanian@devinemillimet.com

DEVINEMILLIMET.COM

TAXENEWS@DEVINEMILLIMET.COM

The Legislature did not provide additional guidance on the kinds of records that would be considered acceptable and the Department of Revenue Administration (“DRA”) has not provided additional clarification in the form of Administrative Rules on how they will interpret the BPT recordkeeping requirement. There continues to be ambiguity on what kinds of documents could be considered adequate to support the compensation deduction for an owner-employee of a business.

RECORDS SUPPORTING SERVICES BEING PROVIDED

A review of judicial cases does not provide clear recordkeeping requirements for taxpayers under the federal provisions, but it is possible to get an understanding of the kinds of information that may be needed to support an owner-employee’s compensation. The business organization must be able to demonstrate the role of the owner-employee and his or her importance to the success of the company.

This goal conceivably could be accomplished using employment agreements that identify key services provided and the methodology for compensating the individual for such services. These agreements are beneficial because they are entered into by a legal entity, in cases other than a proprietorship, and the owner-employee and they are enforceable by the courts. Additionally, the business could create and retain contemporaneous notes from a meeting where a company’s partners or members discuss the services to be provided by each individual and the compensation for such services prior to rendering the services. The importance of this approach is the parties would have conflicting interests in establishing a reasonable level of compensation for the services provided and the notes would identify the services that are provided by each individual.

The judicial cases also consider the existence or non-existence of a conflict of interest between the parties in evaluating whether the compensation is reasonable. Where there is no conflict of interest present, the courts generally pay closer scrutiny to the issue because it is easier to disguise a potential dividend in the form of compensation. Greater evidence supporting the reasonableness of the compensation and the presence of an adequate level of return on the owner’s equity may be required in such instances.

Any personal calendars, appointment notes, comments entered on the owner-employee’s PDA devices, such as their I-Phone or Blackberry, regarding business activities or other business records that demonstrate the activities of the owner-employee should be retained. Examples of such records may be sales reports in the case of an individual who is involved in the marketing side of the

Office Locations:

111 Amherst Street
Manchester, NH 03101
T 603.669.1000
F 603.669.8547

43 North Main Street
Concord, NH 03301
T 603.226.1000
F 603.226.1001

business, contracts or other agreements requiring the skills of the owner-employee that may have been negotiated by the individual during the taxable period or other business documents that support the owner-employee's key efforts.

Supporting documentation regarding the services provided and the value of those services should be on a reasonably contemporaneous basis. Testimony from the owner-employee at the time of a hearing may be beneficial in establishing what services were rendered during the appeals process and be admissible as evidence, however, such testimony may not qualify as being "records" as required in the statute. The business organization should be proactive when it comes to the recordkeeping requirement rather than risk the potential loss of the deduction.

Tax preparers can include documentation in their work papers of discussions between themselves and their client on the high-value services that the client provided during a taxable period. The initial detailed documentation may be the most time consuming as only updates or the listing of unusual items would be required in subsequent years. The document should also indicate how the compensation was arrived at as well the methodology for calculating any year-end bonus taken. The preferable time for such a discussion would be during a planning meeting prior to year-end when the profits are not finalized. The earlier in the taxable period such a discussion takes place the better.

RECORDS SUPPORTING REASONABLENESS OF COMPENSATION

We would probably all agree that compensation paid by a similar company to its owner-employee could establish the reasonableness of a deduction; however, outside of companies that are publicly traded, we are unlikely to find such comparative data. Businesses or their tax preparers could use public data sources, including data from publicly traded companies, to evaluate the performance of the business and determine what a reasonable return would be for the capital invested in the business. Establishing what an "independent investor" might expect would assist in determining what a reasonable level of compensation may be. Such an investor would be less willing to compensate an employee based on providing all of the profits for services while not receiving a return for the capital invested. Reviewing and using such data on a regular basis could provide evidence that the business was obtaining corroborating evidence to support the reasonableness of their deduction when it was taken on the returns.

Comparing the compensation methodology for the owner-employee and other employees of the business also provides potential

support for the compensation level of the owner-employee. A business that provides, for example, significant bonuses to key employees, other than the owner, for their contributions can support the reasonableness of a compensation plan that includes significant bonuses to the owner-employee whereas only providing significant bonuses to the owner-employee would produce the opposite result.

Judicial cases have accepted incentive compensation programs that were established and followed for a number of years provided that the program was reasonable when first established - even in instances which results in a windfall in a subsequent year. Adopting such incentive plans could simply be incorporated within an employment agreement outlining the responsibilities of the individual and how the base salary and incentive compensation would be determined.

Small business owners may question the value of maintaining such documentation since it is their company and their money, however, the recordkeeping requirement has been clearly stated by the Legislature in the 2011 amendment to the BPT compensation deduction. The items that we have discussed may go a long way in providing support that services were rendered and there is a basis that the compensation was reasonable under the standards identified within RSA 77-A:4, III (b).

CONCLUSION

Maintaining records that services were provided and complying with the requirements in RSA 77-A:4, III (b) and RSA 77-A:11, I will shift the burden of proof regarding the reasonableness of the compensation deduction from the business organization to the DRA. When the burden shifts, *“...the amount claimed as a deduction shall be presumed to be reasonable, unless the commissioner proves by a preponderance of the evidence that the deduction claimed by the business organization is clearly unreasonable.”* Emphasis Added

A failure to maintain some records demonstrating that services were rendered and the reasonableness of the compensation deduction, as required by the statute, may result in the full denial of the deduction rather than shifting the burden of proof to the DRA. The statutory changes are effective for all taxable periods beginning on or after January 1, 2011. Time is of the essence and taxpayers can no longer wait until they receive the appointment letter from the DRA scheduling an audit of the return to put together records which purport to justify the compensation deducted. It is important that you discuss these statutory changes with your clients so that they are aware of the risks associated with not maintaining some records to support their compensation deduction. A potential complete

disallowance of the deduction, after an audit by the DRA, for the failure to maintain some records about the services rendered and their value to the business is obviously an avoidable risk to your clients.

Our Tax Practice Group can assist you or your clients in reviewing these statutory requirements and developing supporting documentation that would be beneficial to the business organization should the DRA challenge the compensation deduction. We have developed employment agreements and incentive compensation methodologies for clients in various industries and are ready to assist you.

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