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The ‘reasonable comp’ balance of power

Business owners can breathe a little easier if either of the two "reasonable comp" bills currently before the Legislature becomes law.

The so-called "reasonable compensation" deduction under state law permits unincorporated businesses to deduct a "fair and reasonable" amount for personal services provided by its owners from the organization's business profits. The New Hampshire Department of Revenue Administration has challenged the amount of the deduction taken by businesses with increasing frequency, and as any small-business owner with the misfortune of enduring such a challenge can attest, the department holds all the cards.

Two bills currently pending in the New Hampshire Legislature, Senate Bill 125 and House Bill 557, are attempting to level the playing field.

The department's current advantage lies in the fact that the burden of demonstrating the reasonableness of the compensation deduction is on the business organization. In practice, this means that if the department challenges the amount of the deduction taken by a business, there is an assumption that the amount is unreasonable and the department's adjustment to the deduction is correct. A business owner must either accede to the department's determination of the value of his services and pay the associated tax assessment, regardless of the merits of the department's position, or prove the reasonableness of the deduction (by a "preponderance of the evidence"), which often involves significant time and expense for the owner.

The decision of whether to challenge the department's assessment can be a difficult one, as illustrated by a former client we will call Mr. X.

Mr. X is a small-business owner. His service-oriented business involved very little overhead. Although he had several employees who provided support, he was the sole revenue producer for the business, which operated within a very distinct niche of a larger industry.

The department audited Mr. X's business, resulting in an issue with the amount of the business's reasonable compensation deduction for compensation paid to Mr. X. At the conclusion of the audit, the department issued a significant tax assessment based on the amount of compensation deduction it was willing to allow. The department calculated the disallowance of compensation by comparing the deduction taken with the average hourly wage figure listed in the New Hampshire Occupational Employment & Wages publication for what the department deemed an equivalent job title.

Mr. X perceived two fundamental flaws with the department's approach. First, the average hourly wage figure the department used as Mr. X's reasonable compensation inaccurately represented the work Mr. X performed and failed to consider the industry or niche in which the business operated. Second, the amount determined as reasonable by the department did not represent what someone performing the services of Mr. X would expect to earn elsewhere, which the department is required to consider.

Anyone with Mr. X's experience and connections who achieved such exceptional results would not work for average compensation and a business could not find someone of Mr. X's caliber by paying average compensation.

Despite these legitimate concerns, Mr. X found himself in the difficult position of deciding whether to challenge the tax assessment. In such a challenge, the department would be presumed correct, and he would bear the burden of proving otherwise. Adding to the complexity of the situation, the department offered to "settle" the matter for approximately half of its original assessment. Settling the matter for half the amount of the assessment and moving on had its appeal, but could also set a precedent for subsequent years.

Shifting the burden

Mr. X may not have ended up in this situation if the legislation currently pending before the Legislature was in place. Both SB 125 and HB 557 would have required Mr. X to prove that he actually provided services to the business organization during the taxable period. At that point, the burden would then have shifted to the department to establish that his compensation was "grossly excessive" or "clearly unreasonable," depending on the final language of the bill.

Though the meanings of these standards have not been fully articulated yet, clearly the department would have been required to go well beyond the analysis it actually performed in order to prove that the compensation was not deductible.

Predictions about either bill's potential effect on the state's tax revenue vary widely. The department projects a very significant revenue loss. Others predict a considerably less-noticeable effect on the state's tax revenue, noting that the standard will remain whether compensation is "fair and reasonable," and business owners will still need to prove that services were actually rendered. Though the result will likely be somewhere in between, business owners should be paying close attention to these bills as well as reviewing their compensation, documenting the services they provide and developing the necessary contemporaneous documentation to support the amount of any deduction.

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