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The general rule is that wages paid to employees, including the compensation for business owners, is deductible by the employer. However, if amounts are excessive and unreasonable for services actually rendered, the full amount can't be deducted. The IRS and taxpayers often fight out this "reasonable compensation" issue in the courts.

In a new case, the Tax Court has ruled that a company in the concrete business could deduct the millions it paid to each of the founder's sons. The Court was swayed by the overwhelming evidence presented on behalf of the taxpayer.

Here are the main facts of the case: H.W. Johnson was a concrete contracting employer owned by the retired founder's wife (51 percent interest) and each of his two sons (24.5 percent each). It was one of the largest concrete contractors in the Arizona with over 200 employees and contract revenues of $23.7 million in 2003 and $38 million in 2004.

The business revenue grew rapidly from about $4 million in 1993 after the sons assumed control of daily operations. The two brothers managed all operational aspects, including contract bidding and negotiation, project scheduling and management, equipment purchase and modification, personnel management and customer relations. Each one supervised over 100 employees in their respective divisions, including superintendents and foremen, and worked 10 to 12 hours a day, five to six days a week. They were also known for their hands-on style.

The company had an excellent reputation with developers, inspectors and other

million paid to the sons in 2003 and 2004, respectively. The IRS audited the business and partially disallowed the deductions for compensation. It said that approximately $811,000 of the amount deducted for 2003 and $769,000 for 2004 didn't constitute reasonable compensation.

Based on the landmark *Elliots* case decided by the Ninth Circuit (the court which would have handled an appeal of this case), five factors are traditionally used to determine if compensation is reasonable. They are:

1. The employee's role in the company.
2. An external comparison to other businesses
3. The character and condition of the business
4. Whether there is a conflict of interest regarding the negotiation of compensation.
5. Whether there is internal consistency in a company's treatment of payments to employees.

Concrete result: After reviewing the *Elliots* factors, the Tax Court found that the brothers were absolutely integral to the success of the business, citing phenomenal growth in revenues, assets and gross profit margins during the tax years at issue. The return on equity generated for each year after payment of their compensation closely approximated the return generated by comparable companies. Thus, the Court said that the compensation paid to the brothers in 2003 and 2004 was, in fact, reasonable under the circumstances (H. W. Johnson, Inc., TC Memo 2016-95, 5/11/18).

If you anticipate a potential challenge to a business client's compensation deduction, line up the proof that the amounts are justified. The client's position may be bolstered by financial records and stipulations in the corporate minutes as to why specific compensation amounts are being paid. This is especially important where six-figure salaries are being paid to higher-ups or members of an owner's family.

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