

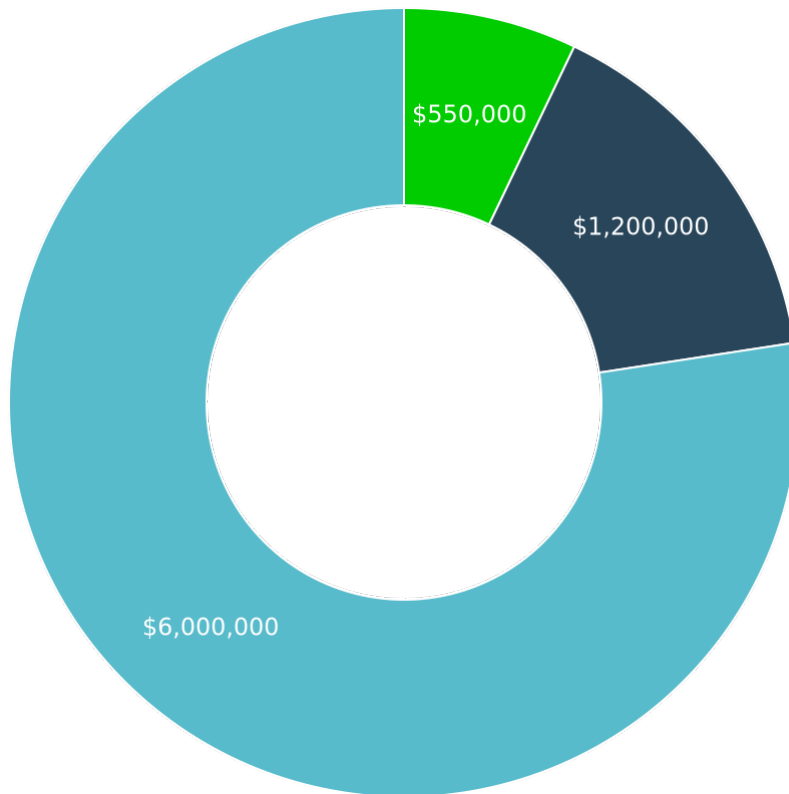


Your estimated annual Reasonable Compensation: \$550,000

Thank you for entrusting Paul Hamann of Potomac Tax and Valuation, PC with your Reasonable Compensation analysis. This report provides a reasonable estimate of the value of services rendered to your C Corporation based on the increase in fair market value attributed to your efforts. Reasonable Compensation is defined by the IRS as "The value that would ordinarily be paid for like services by like enterprises under like circumstances."

The calculated salary of \$550,000 was determined to be Reasonable Compensation based on the increase in the Fair Market Value of your company over a one year time frame and a Return on Investment of 20% in conjunction with your efforts.

Potomac Tax and Valuation, PC recommends completing a Reasonable Compensation report annually.



Reasonable Compensation Return on Equity (Year End) Fair Market Value (Year Start)



POTOMAC

Tax & Valuation

Year: 20XX

Report: Tax Compliance for C Corp

Approach: Income (AKA Independent Investors test)

For: Scott Stone of Stone Concrete, Inc.

Business Summary:

Calculated for:	Scott Stone
Company:	Stone Concrete, Inc.
Interview Completed Date:	20XX-12-08 08:56
Report Calendar Year:	20XX
Fair Market Value (Start):	\$6,000,000
FMV Increase:	\$1,750,000
Target Return on Equity:	20%
Return on Equity (after Compensation):	\$1,200,000



How was my "Annual Salary" or "Reasonable Compensation" calculated?

Potomac Tax and Valuation, PC relies on the IRS formula for determining Reasonable Compensation using the Income Approach (aka The Independent Investors Test) as outlined in the IRS Job Aid: Reasonable Compensation for IRS Valuation Professionals.

This report determines Reasonable Compensation based on the increase in Fair Market Value (FMV) of the business over a one year time frame and a target rate of return. The owner's Reasonable Compensation is computed based on the following formulas:

$$\begin{aligned} &\text{Increase in FMV over the year before Reasonable} \\ &\text{Compensation -} \\ &(\text{Target Return} \times \text{FMV at the beginning of the year}) = \\ &\text{Reasonable Compensation} \end{aligned}$$

Reasonable Compensation figures include taxable **Medicare** wages and flexible spending accounts. Reasonable Compensation figures do not include non-taxable fringe benefits such as health insurance, vehicle or vehicle allowance, stock options, company loans and other items not reported on a W-2 as **Medicare** wages.

Your actual replacement salary could vary considerably from our estimate, especially if the FMV estimates differ substantially from actual figures.

Methodology

This report uses the Income Approach to determine a Reasonable Compensation figure. The Income Approach determines whether a hypothetical investor would be satisfied with their return on investment when looking at the financial performance of the business in conjunction with the compensation level of the owner.

The income approach can only be correctly applied when the Fair Market Value (FMV) of the company is available for each year that compensation is being examined.

The rationale behind the Independent Investor Test is that investors pay employees to increase the value of the assets entrusted to their management. A high rate of return indicates that the assets' value increased and that the employee provided valuable services. Thus, if investors obtain returns above what they should reasonably expect, an employee's salary is presumptively reasonable.

The Income approach generally works best when there is no comparability data available.

For more information on Methodologies:

- [Job Aid for IRS Valuation Professionals](#)
- Reasonable Compensation Reports, Inc. Methodology Report (available upon request)



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Other considerations before deciding on a final Reasonable Compensation figure

Potomac Tax and Valuation, PC may take into consideration before recommending a final Reasonable Compensation figure. The list below is not exhaustive and Potomac Tax and Valuation, PC may make adjustments for circumstances and situations not listed:

- Compensation of Non-Owner Employees
- Salary History
- Travel Requirements
- Personal Guarantee of Debt
- Key Relationships and/or Contracts
- Financial Condition of Company
- Distribution History

The courts have used a variety of factors to "Stress Test" Reasonable Compensation figures. Four well recognized lists of factors are below. Potomac Tax and Valuation, PC may stress test your Reasonable Compensation figure against some or all of the factors used by the courts and the IRS and recommend adjustments.

1. The IRS Nine Factors Considered by Tax Courts: [IRS Fact Sheet 2008-25](#)
2. The Tax Court's Five-Factor Test: [LabelGraphics, Inc. v. Commissioner, T.C. Memo 1998-343 \(Sept. 28, 1998\)](#)
3. The Tax Court's Ten-Factor Test: [Brewer Quality Homes, Inc. v. Commissioner, T.C. Memo 2003-200 \(July 10, 2003\)](#)
4. Summary of Court Factors used to "Stress Test" Reasonable Compensation Figures: [Summary](#)

Additional information and help on the issue of Reasonable Compensation for C Corporation owners can be found at:

- [IRS: Tests for Deducting Pay](#)
- [IRS: Treatment of excessive compensation](#)
- [IRS: Instructions for Form 1125-E](#)

Additional Resources:

- [Job Aid for IRS Valuation Professionals](#)
- [Reasonable Compensation: Application and Analysis for Appraisal, Tax and Management Purposes. By Ronald L. Seigneur and Kevin R. Yeanoplos](#)



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Sample Language for Your Corporate Minutes

Potomac Tax and Valuation, PC recommends incorporating the results of this report into the Corporate Minutes of your C Corporation.

Here is a sample document for that purpose:

CONSENT AND MINUTES OF MEETING OF DIRECTORS OF Stone Concrete, Inc.

The undersigned, being all of the directors of Stone Concrete, Inc. (the "Company"), waive any rights to notice, and consent to the following action, taken on

_____, 20____ :

RESOLVED, that the Company adopt the report of Potomac Tax and Valuation, PC, a copy of which is attached and, in reliance on such report, pay to Scott Stone the sum of \$550,000 per year as salary for the duties set forth in such report.

DISCLAIMER NOTICE!

This document is being provided merely as a sample of the type of language that the C Corporation may consider using in connection with minutes of the board of directors adopting the amounts determined by Potomac Tax and Valuation, PC as Reasonable Compensation for its employees.

Potomac Tax and Valuation, PC does not provide legal services, and does not represent that this sample will comply with state laws regarding the procedure for actions of the C Corporation's board of directors or the form or content of the minutes memorializing such actions.

Potomac Tax and Valuation, PC recommends that the C Corporation consult its attorney for legal advice regarding such matters.