MSO Management: A Structured *Approach* to Setting and Supporting MSO Fees

By Todd Mezrah

Introduction

Mezrah Consulting has partnered with Guardian Tax Consultants ("Guardian") to provide Management Services Organization ("MSO") services which include MSO setup, compliance and fee determination.

Guardian is regarded as an industry authority, and the following outlines their thoughtful, and diligent approach to determining MSO fees in a manner consistent with IRS code provisions.

What We Do

Purpose

A management fee range for an MSO should be rooted in services actually provided and properly documented so it is deductible under Internal Revenue Code ("IRC") Section ("§") 162 and arm's-length under IRC § 482.

What This Approach Solves

Related-party management fees can be challenged when they appear arbitrary, duplicative, or untethered to services. This framework addresses those potential pitfalls by (i) building the fee from an independently established labor base, (ii) using recognized IRC § 482 methods to define a defensible range instead of a single number, and (iii) maintaining a contemporaneous, exam-ready file each year.

Key Commitments in the Approach	How the Framework Works
Independence: two separate third parties—a reasonable compensation analysis ("RCA") expert to determine direct labor, and a Certified Public Accountant ("CPA")/tax attorney valuation expert to set the fee range.	**Independent RCA Base:** A third-party compensation expert establishes the direct labor cost base.
Method Discipline: apply the best method under Treasury Regulation ("Reg.") § 1.482-1; use the alternative method only as corroboration.	**Fee Range by Independent Valuation:** A separate tax attorney/CPA valuation expert builds a defensible range using a conservative cost-plus floor and an Industry Margin Cross-Check (Gross Services Margin/ Comparable Profits Method).
Profit Motive: the MSO earns a modest profit on total service costs (no "zero-profit" shells). Must comply with § 162 ordinary-expense deductibility and § 482 arm's-length compliance.	**Industry Evaluation:** is completed to determine the average profitability taking into consideration the client's specific percentage of profit.
Documentation: signed agreements, W-2 payroll, time logs, allocation workpapers, monthly invoices, annual memo refresh.	**Annual Refresh:** An exam-ready binder (agreements, W-2s, logs, invoices, memos).

The Method – Steps and Rules

Step 1 – Build Total Services Costs (“TSC”)

- **Direct Labor (“DL”):** An independent RCA determination is obtained by role, hours, geography, and proficiency.
- **Overhead (“OH”):** Indirect costs allocated per Reg. § 1.482-9(j),(k) using reasonable drivers (e.g., payroll/time basis, headcount, square footage).
- **TSC = DL + OH.**
  Note: In practice, OH allocations are based on documented cost drivers. The 15% in the numeric example is illustrative only.

Step 2 – Adjust and Establish the Cost-Plus Floor

- **A – Include SG&A if Applicable**
  If selling, general and administrative (“SG&A”) expenses (e.g., Human Resources, IT, office administration) are incurred centrally in the MSO and not already captured in OH, they may be added to TSC. These costs must be documented and reasonably allocated across all benefiting operating companies (per Reg. § 1.482-9(b)(7)). Exclude general shareholder or financing costs not tied to services. Once included, recalculate both the Cost-Plus floor and the Industry Margin Cross-Check using the adjusted TSC to avoid double counting.
- **B – Set the Low-End (Floor) with Cost-Plus**
  - Profit = 15% × TSC (adjusted if SG&A included).
  - Fee (Low[1]) = TSC + Profit.

Clarification: No safe harbor exists for 15%. A 15% profit on TSC is adopted here as a policy floor to evidence profit motive under IRC § 162 and falls within the **interquartile range (10–25%)** commonly observed in IRS APA and industry databases. OH and SG&A must be calculated and supported, not assumed.

Step 3 – Set the High-End (Ceiling) with Industry Margin Cross-Check

Recognized IRC § 482 methods are applied to establish the high-end of the fee range, with one method chosen as the best method and the other used as corroboration:

Gross Services Margin (“GSM”) Method	Compares the MSO’s gross services margin to independent providers; Fee = TSC ÷ (1 − GSM%).
Comparable Profits Method (“CPM”)	Tests profit-level indicators (e.g., Operating Profit (“OP”) ÷ TSC) against comparable service providers; Fee = TSC × (1 + OP/TSC%).

Comparables are sourced from industry benchmarking services (e.g., CSI Market) and independent profitability databases used in IRC § 482 analyses. The chosen method must be justified as the best method under Reg. § 1.482-1(c) based on data quality, comparability, and reliability.

[1] *The “low” part of the fee—the Cost-Plus floor—represents the minimum defensible, profit-motivated amount the MSO must charge to be recognized as a legitimate trade or business under IRC § 162 and compliant with § 482.*

Step 4 – Consider Intangibles in Fee Determination

When labor is shifted into the MSO, certain intangibles move with it and form part of the service value. These may include personal guarantees of debt, key relationships and know-how, tenure and continuity of leadership or critical employees, and operational responsibility and risk assumed by the MSO. These factors are evaluated qualitatively—they do not create additional fees beyond the cost-plus floor or industry ceiling, but explain why a final fee may reasonably sit above the floor within the established range.

Step 5 – Multi-Operating Company (“OpCo”) Allocation

A single total fee is computed, then allocated consistently across OpCos per Reg. § 1.482-9(b)(7), based on reasonably anticipated benefits.

Step 6 – Annual Refresh

This process is refreshed annually: Reasonable compensation analysis is re-run, NAICS/industry margins are re-benchmarked, three-year OpCo results are updated, and a new memo is issued. Agreements, W-2s, logs, and invoices are kept current to preserve contemporaneity and exam readiness.

Numeric Example, Authorities, Risk Controls

Worked Example (illustrative)

Inputs:

- Direct Labor (DL): $671,124
- Overhead (OH): 15% of DL = $100,669
- SG&A (if applicable): $50,000 documented and allocated
- Total Services Costs (TSC): DL + OH + SG&A = $821,793

Low-End (Cost-Plus Floor)	• **Profit = 15% × TSC = $123,269** • **Fee(Low) = $821,793 + $123,269 = $945,062**
High-End (Industry Margin Cross-Check)	• **GSM method: GSM% = 40% ⇒ Fee = $821,793 ÷ (1 − 0.40) = $1,369,655** • **CPM corroboration: OP/TSC% = 25% ⇒ Fee = $821,793 × 1.25 = $1,027,241**
Range	**$945,062 ⇒ $1,369,655**
Selection	**Final fee is chosen within this range, supported by qualitative intangibles. CPM provides corroboration.**

Authorities for the Example

- IRC § 162; Reg. § 1.162-7 – Compensation must be reasonable and for services actually rendered.
- IRC § 482; Reg. § 1.482-9 – Recognizes GSM, CPM, and cost-of-services-plus for services.
- Reg. § 1.482-9(b)(7) – Shared-services allocations based on reasonably anticipated benefits and consistent application.
- **Case law:** H.W. Johnson (T.C. 2016-95) - administration fee upheld; Aspro (8th Cir. 2022) and Weekend Warrior (T.C. 2011-105) - fees disallowed when not tied to services; Mayson, Elliotts, Exacto - reasonable compensation tests.
- Rev. Rul. 2008-39; Rev. Proc. 2007-13 – analogous guidance on management fees and low/no markup for routine services.

Risk Control Measures for Example

- **Low risk:** Written agreements, W-2s in MSO, supported OH/SG&A, periodic invoicing, RCA + fee valuation memos, annual refresh.
- **Moderate risk:** Missing logs or OH/SG&A support, or fee selection at the upper end without comparables—remediate by collecting logs, supporting allocations, tying to comparables, and documenting final selection.
- **High risk:** No agreements, year-end sweeps, fees tied to ownership, no W-2s—IRS will likely disallow or recharacterize as dividends.

Audit Playbook and Implementation Checklist

How we position this in an exam

- Open with the binder: agreements, org chart, MSO scope, pricing method memo (best-method analysis).
- Walk the agent through TSC construction (DL, OH, SG&A) with allocation workpapers and drivers.
- Show the RCA report (third-party), then the fee-range memo (separate expert).
- Demonstrate the annual refresh cadence and periodic invoicing (no year-end sweeps).
- Walk through GSM/CPM data sources and reliability; explain why the chosen method is the best method.
- Close with the allocation basis across OpCos — consistent, documented, and benefit-based.

Implementation checklist (internal)

- Engage RCA expert; collect role profiles, hours, locations.
- Compile indirect cost pools and choose OH drivers; confirm if any SG&A should be included.
- Engage valuation/tax expert for best-method analysis and fee-range memo.
- Draft/update management services agreement; define scope, pricing, allocation basis, and invoicing cadence.
- Establish time logging and monthly invoicing; centralize workpapers (binder).
- Calendar annual refresh; assign owners and due dates.

Please note the above discussion is not intended to be inclusive of all tax code sections that may apply. Mezrah Consulting and its affiliates are not tax professionals, and this document should not be considered tax advice or guidance.

More Information

For more information, email Mezrah Consulting at connect@mezrahconsulting.com or call (813) 367-1111. Visit our website at mezrahconsulting.com to learn more.

Who We Are

Mezrah Consulting, based in Tampa, Florida, is a national executive benefits and compensation consulting firm specializing in plans for sizable publicly traded and privately held companies. For more than 30 years, we have focused on the design, funding, implementation, securitization and administration of nonqualified executive benefit programs, and have advised more than 300 companies throughout the U.S.

As a knowledge-based and strategy-driven company, we offer clients highly creative and innovative solutions by uncovering value and recognizing risks that other firms typically do not see. Custom nonqualified benefit plans are administered through our affiliate map*benefits*®, a proprietary cloud-based plan technology platform that provides enterprise plan administration for nonqualified plans, including reporting and functionality for plan participants and plan sponsors.