



DEFENSE CONTRACT AUDIT AGENCY  
DEPARTMENT OF DEFENSE  
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IN REPLY REFER TO

PPD 730.5.45.1

December 17, 2003  
03-PPD-083(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA  
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Federal Acquisition Regulation (FAR) Final Rule,  
Compensation Cost Principle

This memorandum provides audit guidance regarding the subject final rule. The Civilian Agency Acquisition Council and the Defense Acquisition Council have revised the compensation cost principle at FAR 31.205-6 by restructuring the paragraphs, and by removing unnecessary and duplicative language. The rule published in the Federal Register on July 24, 2003 was effective August 25, 2003.

Significant Change - The most significant change made in the cost principle was a clarification that **compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total** (FAR 31.205-6(b)(2)). The prior cost principle stated that compensation will be considered reasonable if each allowable element making up the employee's compensation package is reasonable. It further stated that upon challenge of the reasonableness of any individual element or the sum of individual elements, the contractor must demonstrate the reasonableness of the compensation item in question and in doing so has the right to introduce offsetting compensation elements into consideration. The Councils believe that compensation should be reviewed for reasonableness in total by employee or job class of employee and that "offsets" are implied in this concept. Also, it is noted that the concept of "review of total compensation reasonableness" does not waive the Government's right to review individual compensation elements in order to determine total compensation reasonableness. This concept recognizes the difficulty in determining the reasonableness of total compensation without reviewing individual elements because reliable surveys of "total compensation" do not exist. (See the enclosed Federal Register Final Rule - Councils' response to Public Comments 3 and 9).

Impact of Significant Change on Agency CAM guidance - The Agency's approach to performing a compensation system audit and the testing of the reasonableness of compensation costs will remain basically unchanged. FAR 31.205-6(b) will continue to be cited in audits of contractor compensation systems and in the determination of the reasonableness of compensation. However, because FAR 31.205-6(b)(2) now provides that compensation is reasonable in the aggregate if each measurable and allowable element sums to a reasonable total, there are forthcoming guidance clarifications. For example:

- CAM 6-413.3f(2) will be clarified to have the contractor make a preliminary assessment of the aggregate of compensation elements, and emphasize that offsets are implied in this

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“aggregate” concept, prior to expending considerable resources in performing an independent test of reasonableness.

- CAM sections 5-800 (Compensation System Reviews (CSR) and Audit of Internal Control) and 6-413 (Reasonableness of Compensation Costs) will be updated to state that contractors will no longer have to *propose offsets* in order to establish total reasonableness and that the concept of *review of total compensation reasonableness* does not waive the Government’s right to review individual compensation elements.

Other Changes – The other FAR 31.205-6 changes are summarized below. They are clarifications to the compensation cost principle. The Agency’s approach to performing a CSR and the testing of the allowability and reasonableness of compensation costs will remain unchanged. However, the FAR clarifications will result in Agency guidance clarifications effecting CAM paragraphs 5-800, 6-413, and 6-414.

- The compensation general allowability criteria were clarified in:
  - FAR 31.205-6(a)(2) – The phrase *the total compensation for individual employees or job classes of employees must be reasonable for the work performed* was clarified to make the reference consistent throughout the cost principle.
  - FAR 31.205-6(a)(4) and (5) – In both paragraphs, sentences were combined to clarify the text associated with (i) the concept of no presumption of allowability (31.205-6(a)(4)) and (ii) costs that are unallowable (31.205-6(a)(5)).
  - FAR 31.205-6(a)(6) – This paragraph, dealing with the compensation costs for certain individuals giving rise to the need for special consideration, had previously been included under the reasonableness criteria at FAR 31.205-6(b)(2)(i) and was moved here and clarified.
- The definition of compensation had previously been included under the FAR 31.205-6(a) general compensation criteria and was moved to FAR 31.001.
- All reasonableness provisions, including those dealing with labor-management agreements were consolidated in paragraph FAR 31.205-6(b).
  - FAR 31.205-6(b)(1) – The paragraph, dealing with compensation pursuant to labor-management agreements, had previously been included under FAR 31.205-6(c) and was moved to 31.205-6(b)(1) and clarified. FAR 31.205-6(c) is now reserved.
  - FAR 31.205-6(b)(2) – The paragraph, dealing with compensation not covered by labor-management agreements, was clarified in regards to the aggregate of each measurable and allowable element as previously discussed. Clarifications to remove redundancies and improve text structure were also made.

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- The language in the prior FAR 31.205-6(b) that placed the burden of demonstrating reasonableness on the contractor, when the compensation reasonableness was challenged, was deleted. It was considered redundant of the language currently found in FAR 31.201-3(a) which also levies the burden of proof upon the contractor for establishing the reasonableness of challenged costs.
- The language in the prior FAR 31.205-6(b) which discussed challenging increased compensation costs when major revisions or compensation plans are introduced was deleted because it was considered duplicative of the concept in FAR 31.205-6(a)(4).
- FAR paragraphs 31.205-6(d) – Form of Payment; 31.205-6(e) – Income Tax Differential; 31.205-6(f) – Bonuses and Incentive Compensation; 31.205-6(g) – Severance Pay; and 31.205-6(h) – Backpay are clarified in such areas as format, reduced wordiness, and removal of unnecessary and redundant phrases.

Enclosed is the Federal Register final rule publication of the FAR compensation cost principle. Included in the final rule publication is supplementary information that includes published public comments. Note that references to sections in the cost principle in the public comments do not correlate directly with those in the final cost principle due to changes made in the cost principle structure after the public comments were considered.

Field audit office questions regarding this memorandum should be addressed to the regional office. Regional personnel with questions regarding the changes to the cost principle may contact Ms Rose Autmon, Program Manager, Accounting and Cost Principles Division at (703) 767-3250. Questions regarding reviews of compensation systems may be addressed to Mr. John Galiatsos, Program Manager, Policy Programs Division at (703) 767-2270.

/Signed/  
Robert DiMucci  
Assistant Director  
Policy and Plans

Enclosure:  
Federal Acquisition Regulation (FAR) Final Rule,  
Compensation Cost Principle

DISTRIBUTION: C

**DEPARTMENT OF DEFENSE  
GENERAL SERVICES ADMINISTRATION  
NATIONAL AERONAUTICS AND  
SPACE ADMINISTRATION**

48 CFR Parts 22, 31, 37, and 52  
[FAC 2001–15; FAR Case 2001–008; Item IV]

RIN 9000–AJ36

Federal Acquisition Regulation; Compensation Cost Principle

AGENCIES: Department of Defense (DoD), General Services Administration (GSA), and National Aeronautics and Space Administration (NASA).

ACTION: Final rule.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council (Councils) have agreed on a final rule amending the Federal Acquisition Regulation (FAR) to revise the “compensation for personal services” cost principle by restructuring the paragraphs, and by removing unnecessary and duplicative language.

DATES: *Effective Date:* August 25, 2003.

FOR FURTHER INFORMATION CONTACT: The FAR Secretariat, Room 4035, GS Building, Washington, DC 20405, (202) 501–4755, for information pertaining to status or publication schedules. For clarification of content, contact Mr. Edward Loeb, Procurement Analyst, at (202) 501–0650. Please cite FAC 2001–15, FAR case 2001–008.

SUPPLEMENTARY INFORMATION:

**A. Background**

DoD, GSA, and NASA published a proposed rule in the **Federal Register** at 67 FR 19952, April 23, 2002, with request for comments. Three respondents submitted public comments. A discussion of the comments is provided below. Differences between the proposed and the final rule are discussed in paragraphs 1, 5, 13, 15, and 19 below.

*Public Comments:*

1. *Comment: Designate FAR 31.205–6(c) as Reserved.* The current paragraph designations, especially paragraph (j) for pensions, have been cited in many court cases, Government contracts, and other

documents over the years. All the respondents expressed concerns that the re-designation of paragraphs (d) through (p) within FAR 31.205–6 as paragraphs (c) through (o) would create confusion.

*Councils' response:* Concur.

2. *Comment:* Move proposed FAR 31.205–6(g)(1) (*Backpay*) to FAR 31.205–6(a)(1). The respondent did not provide an explanation for this recommendation.

*Councils' response.* Do not concur. The Councils believe there is merit in maintaining a separate paragraph for backpay. See paragraph 16 for further discussion.

3. *Comment:* Delete proposed FAR 31.205–6(a)(2) (*total compensation*). The language is duplicative of FAR 31.201–3, Reasonableness, and the focus of the cost principle should be on the reasonableness of a contractor's total compensation plan and not on individual employees or job classes.

*Councils' response.* Do not concur. The proposed paragraph makes it clear that, although compensation must conform to FAR 31.201–3, it must also conform to the more specific provisions contained in this cost principle. The Councils do not agree with the concept that the reasonableness of compensation should be based “solely” on the contractor's total compensation plan, without consideration of the reasonableness of the compensation for individual employees or job classes of employees. See paragraph 9 for further discussion.

4. *Comment:* Delete proposed FAR 31.205–6(a)(5) (*unallowable cost*). The proposed language states: “Costs that are unallowable under other paragraphs of this Subpart 31.2 are not allowable under this subsection 31.205–6 solely on the basis that they constitute compensation for personal services.” lieu of the above statement, the respondent suggested adding the following language to FAR 31.204(c): “Cost made specifically unallowable under one cost principle in this subpart are not allowable under any other cost principle.”

*Councils' response:* Do not concur. Similar proposals for such a global policy statement were rejected in the past by both industry and the Government. The current language at FAR 31.204© was adopted instead, and the “unallowable under other paragraphs” statements in individual cost principles were retained. The Councils agree with the original drafters of the current FAR 31.205–6(a)(5) that this language is needed to avoid a situation in which activity that is specifically designated unallowable in another cost principle becomes allowable merely because it meets the criteria for allowable “compensation.”

5. *Comment:* Modify proposed FAR 31.205–6(a)(6)(i) (*partners and sole proprietors*).

Reinstate the following portion of the current language included in FAR 31.205–6(b)(2)(i): “Compensation in lieu of salary for services rendered by partners and sole proprietors will be allowed to the extent that it is reasonable and does not constitute a distribution of profits.”

This insertion would become 31.205–6(a)(6)(i)(C). “Without this reinstatement costs previously allowed could become unallowable since there are instances where these costs are not distribution of profits and the deductible amount is zero.”

*Councils' response:* Partially concur. Historically, the tax deductibility limitation on allowable compensation the cost principle is solely for closely held corporations. The Councils did not intend to change the allowability of costs in this area. However, the proposed rule inadvertently removed the qualifying phrase for “closely held corporations.” In addition, the editorial restructuring unintentionally changed the allowability of costs covered by this subsection. Accordingly, the Councils have revised FAR 31.205–6(a)(6) to clarify and rectify this situation.

6. *Comment: Remove phrase in proposed FAR 31.205–6(a)(6)(ii)(A) (distribution of profits).*  
Remove the unnecessary phrase “which is not an allowable cost.”  
*Councils’ response:* Do not concur. The Councils’ rationale for keeping this phrase is to affirm the unallowability of profit distributions.
7. *Comment: Revise proposed FAR 31.205–6(b)(1) (labor-management agreements).*  
Reposition the word “negotiated” and add the word “set” to the first sentence.  
*Councils’ response:* Do not concur. The Councils do not believe it improves the readability of this paragraph.
8. *Comment: Express rationale for deletion of current FAR 31.205–6(c)(1) and (c)(2) (unusual conditions).* “To make clear the contractor still has the opportunity to justify cost and consideration of unusual conditions(,) include express reason for language deletion of original rule sections(c)(1) and (c)(2).”  
*Councils’ response:* These paragraphs (c)(1) and (c)(2) were deleted because such guidance is not necessary in the cost principle.
9. *Comment: Revise proposed FAR31.205–6(b)(2) (total compensation).* Revise FAR 31.205–6(b)(2) to reflect the concept that reasonableness of compensation should be reviewed at the total compensation plan(s) level and not at an individual employee or job class level.  
*Councils’ response:* Do not concur. Contractors should be able to determine their own mix of wages, bonuses, and benefits to fit the needs of their business and workforce. The Councils believe that compensation should be reviewed for reasonableness in total by employee or job class of employee and that “offsets” are implied in this concept. It should be noted that the concept of “review of total compensation reasonableness” does not waive the Government’s right to review individual compensation elements in order to determine total reasonableness. It is impossible to determine the reasonableness of total compensation without reviewing individual compensation elements because reliable surveys of “total compensation” do not exist.
10. *Comment: Revise proposed FAR 31.205–6(b)(2) (ACO consideration).* Eliminate ACO consideration of the listed reasonableness factors and rely only on FAR 31.201–3 for determining reasonableness since rule enforcement should not vary according to individual ACO determination of relevancy. This list could cause misapplication, *e.g.*, have to consider all four factors in each related to proposed FAR 31.205–6(b)(2)(iv), if factors remain. New language is confusing, difficult to understand, and may lead to negative impacts.  
*Councils’ response:* Do not concur. In determining the reasonableness of compensation costs, both the criteria in FAR 31.201–3 and the criteria in FAR 31.205–6(b) should be used. The concept of listing various factors to be considered by the ACO has been in the cost principle for many years. The relevancy determination is an important and proper ACO function. The cost principle should continue to include coverage on the factors to be used in determining reasonableness, as well as the authority of the contracting officer to determine how to weigh such factors. We believe the proposed language is very straightforward and easy to understand.
11. *Comment: Change language in proposed FAR 31.205–6(c)(2)(i) (valuation date).* Suggest adding the phrase “to the employee” at FAR 31.205–6(c)(2)(i) to make clear that the award date is the date that compensation (in the form of securities) is awarded to the employee.

*Councils' response:* Do not concur. The proposed rule is basically the same language as in the current FAR. We merely deleted the term “measurement date” since the definition already included in the cost principle, *i.e.*, “first date the number of shares awarded is known,” is more precise. The proper measurement date is upon the award of the stock; however, this award may be to an employee or to another entity, such as a trust. The respondent’s recommended change would radically alter the current valuation methodology.

12. *Comment: Delete proposed FAR 31.205–6(6)(d) (Income tax differential pay).* Affirmative statements of allowability, such as that included in FAR 31.205–6(d)(1) for foreign differential pay, should not be included in the cost principles. In addition, the domestic differential pay unallowable is not consistent with commercial practices or the allowability of foreign differential pay.

*Councils' response:* Do not concur. The Councils revised this paragraph to apply only to the allowability of differential pay to cover income tax increases due to foreign or domestic assignments. Normally, affirmative statements of allowability are not value-added in a cost principle. However, in this case, coverage making foreign income tax differentials explicitly allowable should remain. If there were no coverage on foreign differentials, reviewers might use FAR 31.204(c) to find the closest cost principle (domestic differentials) and improperly disallow the costs of foreign differentials. The Councils continue to believe domestic income tax differentials should be unallowable and do not agree with the respondent’s argument that the treatment of domestic differentials has to be consistent with the treatment of foreign differentials. We continue to believe that there should be an incentive for employees to accept foreign assignments.

13. *Comment: Delete proposed FAR 31.205–6(e) (Bonuses and incentive compensation).* Specific limitations on bonuses and incentives are not necessary because these situations are covered by the general reasonableness provisions of FAR 31.201–3(b)(2), generally accepted sound business practices, and the executive compensation cap at FAR 31.205–6(p). “Streamlining should have the goal of defining what is unallowable; illustration of what is allowable makes regulation excessively detailed and cannot be comprehensive.” There is no need to state in the proposed FAR 31.205–6(e)(1)(ii) that the basis of the award must be supported, since adequate documentation is required for all costs. In addition, the proposed paragraph (e)(2) at FAR 31.205–6 regarding deferred bonus and incentive compensation payment is not needed.

*Councils' response.* Do not concur. We have deleted those parts (*e.g.*, the listing of various types of incentive compensation) that the Councils view as unnecessary. It is important for the cost principle to continue to explicitly require that “the basis for the award is supported” in order for the cost to be allowable. This requirement for documenting the basis for the payment is separate and distinct from documenting that the payment was made. In addition, the proposed language at FAR 31.205–6(e)(2) is necessary to ensure deferred bonus payments are subject to both the incentive compensation and the deferred compensation allowability criteria. However, this final rule is deleting the qualifying phrase “based on production, cost reduction, or efficient performance” which is current in the proposed rule at 31.205–6(e)(1). Although we generally agree that such criteria may be good standards for determining allowability, we do not believe that the current rule or proposed rule actually accomplishes this. The wording of the current cost principle or proposed rule may be read as not covering an incentive payment if it doesn’t fall within one of these three criteria, although this is clearly not the intent.

14. *Comment: Delete proposed FAR 31.205–6(f) except for legislative coverage at (f)(5) (Severance pay).* The deleted portion is adequately covered by the reasonableness criteria at FAR 31.201–3.

*Councils’ response:* Do not concur. This paragraph makes it clear that, although severance pay must conform to the general reasonableness criteria of FAR 31.201–3, it must also conform to the more specific provisions contained in this cost principle.

15. *Comment: Deletion of “designee” in FAR 31.205–6(f)(5).* To avoid confusion, suggest that the express reason for deleting the term “designee” in the waiver provision of the proposed FAR 31.205–6(f)(5) be explained.

*Councils’ response:* The term “or designee” is unnecessary because paragraph (b) under FAR 1.108, FAR conventions, states that “each authority is delegable unless specifically stated otherwise (see 1.102–3(b)).” Accordingly, the term has been deleted from the final rule at FAR 31.205–6(g)(6), FAR 37.113–1(a), and FAR 37.113–2(b). To avoid any possible ambiguity in the clauses, “head of the agency, or designee,” was changed to “agency” at FAR provision 52.237–8(a) and (b).

16. *Comment: Modify proposed FAR 31.205–6(g) (Backpay).* Replace the language at FAR 31.205–6(g) with the following sentence: “Backpay resulting from violations of Federal labor laws or the Civil Rights Act of 1964 other than that for work performed is unallowable.” Under the current rule, the “backpay” provisions do not apply unless and until there is a violation of Federal labor laws or the 1964 Civil Rights Act. Until such a violation is found by a court, compensation costs are not covered by these Backpay provisions and they are allowable to the extent they are reasonable as defined by the general reasonableness provisions at FAR 31.201–3 and not limited by additional compensation for work performed. This proposed change could be construed to expand the definition of backpay to now cover retroactive adjustment to salaries or wages for those instances in which there has been no finding of a violation of the 1964 Civil Rights Act or other Federal labor laws and limits recovery to the additional compensation for work performed. Contractors are currently being reimbursed for prudent decisions to save litigation expense by settling wrongful discharge cases for nominal amounts. It is in the Government’s interest to continue to incentivize contractors to make prudent decisions. If the Government begins disallowing all settlements as unallowable “backpay,” contractors may be incentivized to spend more allowable money litigating instead of settling. *Councils’ response.* Do not concur. The Councils rewrote this paragraph to improve its clarity without changing its meaning. Our intent was to emphasize that backpay for underpaid work is the only allowable retroactive adjustment, subject to the specific criteria listed in this paragraph. The current language might be improperly interpreted to mean that if a survey shows an employee is underpaid in a particular year, the contractor could make that underpayment up in a future year. Accordingly, we revised the language of the regulation to preclude such an interpretation. Backpay for underpaid work that does not fall under the current FAR 31.205–6(h) criteria is unallowable, and the proposed FAR 31.205–6(g) language would not change that fact. The respondent’s argument that all settlements would become unallowable is not correct. That part of the settlement that represents backpay for work actually performed is allowable.

17. *Comment: Eliminate FAR 31.205–6(m) (Fringe benefits).* Paragraph (m)(1) is covered by the general reasonableness provisions at FAR 31.201–3, and definitions and examples of allowable cost are not needed, only identification of unallowable cost. “List[s] of compensation elements have been eliminated throughout and should be eliminated here as

well.’’ Paragraph (m)(2), which covers the personal use of company furnished automobiles, should be eliminated unless legislated.

*Councils’ response.* Do not concur. This paragraph needs to be retained as it includes needed criteria for allowability and not just general reasonableness criteria. The language on company furnished automobiles is required by 10 U.S.C. 2324(f)(1)(o).

18. *Comment: Eliminate FAR 31.206–6(n) (Employee rebate and purchase discount plans).* In an effort to move toward commercial practice, suggest the elimination of 31.205–6(n) ‘‘on the basis of immateriality and not cost efficient accounting.’’ Also, employee rebates and purchase discounts are sales reductions and not compensation cost.

*Councils’ response.* Do not concur. Employee rebates and discounts should be considered as a sales reduction; however, Generally Accepted Accounting Principles do allow such costs to be treated as compensation in some limited cases. Therefore, we retained this provision to prevent such sales reductions from being claimed as compensation costs.

19. *Additional change: Reinstate and revise FAR 31.205–6(g)(2)(ii).* This paragraph was deleted in the proposed rule because it was thought to be covered under FAR 31.201–4, Determining allocability. However, upon further analysis, the Councils have reinstated FAR 31.205–6(g)(2)(ii) (as FAR 31.205–6(g)(4) in the final rule) because the language exceeds the requirement stated in FAR 31.201–4 by expressly identifying what method equates to a proper allocation. The specific identification of what constitutes an allocable allocation of normal severance pay has worked and will continue to work to reduce disputes. The paragraph has been revised, however, to enhance its clarity. This is not a significant regulatory action and, therefore, was not subject to review under section 6(b) of Executive Order 12866, Regulatory Planning and Review, dated September 30, 1993. This rule is not a major rule under 5 U.S.C. 804.

### **B. Regulatory Flexibility Act**

The Department of Defense, the General Services Administration, and the National Aeronautics and Space Administration certify that this final rule will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, *et seq.*, because most contracts awarded to small entities use simplified acquisition procedures or are awarded on a competitive, fixed-price basis, and do not require application of the cost principle discussed in this rule.

### **C. Paperwork Reduction Act**

The Paperwork Reduction Act does not apply because the changes to the FAR do not impose information collection requirements that require the approval of the Office of Management and Budget under 44 U.S.C. 3501, *et seq.*

### **List of Subjects in 48 CFR Parts 22, 31, 37, and 52**

Government procurement.

Dated: July 16, 2003.

**Laura Auletta,**

*Director, Acquisition Policy Division.*

- Therefore, DoD, GSA, and NASA amend 48 CFR parts 22, 31, 37, and 52 as set forth below:

- 1. The authority citation for 48 CFR parts 22, 31, 37, and 52 is revised to read as follows:  
**Authority:** 40 U.S.C. 121(c); 10 U.S.C. chapter 137; and 42 U.S.C. 2473(c).

## **PART 22-APPLICATION OF LABOR LAWS TO GOVERNMENT ACQUISITIONS**

22.101-2 [Amended]

- 2. Amend section 22.101-2 in the last sentence of paragraph (a) by removing “31.205-6(c)” and adding “31.205-6(b)” in its place.

## **PART 31—CONTRACT COST PRINCIPLES AND PROCEDURES**

✕ 3. Amend section 31.001 by adding, in alphabetical order, the definition “Compensation for personal services” to read as follows:

### **31.001 Definitions.**

\*\*\*\*\*

Compensation for personal services means all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor.

\*\*\*\*\*

- 4. Amend section 31.205–6 by—
  - a. Revising paragraphs (a) through (h);
  - b. Removing the word “subdivisions” from the last sentence of the introductory text of paragraph (j)(7) and adding “paragraphs” in its place; and removing the word “subdivision” from paragraph (j)(8)(iii) and adding “paragraph” in its place;
  - Removing the word “section” from the introductory text of paragraph (o)(2) and adding “subsection” in its place; and removing the word “subdivision” from the first sentence of paragraph (o)(5) and adding “paragraph” in its place; and
  - d. Removing the colon from the end of the introductory text of paragraph (p)(2) and adding “—” in its place.

The revised text reads as follows:

### **31.205–6 Compensation for personal services.**

(a) General. Compensation for personal services is allowable subject to the following general criteria and additional requirements contained in other parts of this cost principle:

- (1) Compensation for personal services must be for work performed by the employee in the current year and must not represent a retroactive adjustment of prior years’ salaries or wages (but see paragraphs (g), (h), (j), (k), (m), and (o) of this subsection).
- (2) The total compensation for individual employees or job classes of employees must be reasonable for the work performed; however, specific restrictions on individual compensation elements apply when prescribed.

(3) The compensation must be based upon and conform to the terms and conditions of the contractor's established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment.

(4) No presumption of allowability will exist where the contractor introduces major revisions of existing compensation plans or new plans and the contractor has not provided the cognizant ACO, either before implementation or within a reasonable period after it, an opportunity to review the allowability of the changes.

(5) Costs that are unallowable under other paragraphs of this Subpart 31.2 are not allowable under this subsection 31.205-6 solely on the basis that they constitute compensation for personal services.

(6)(i) Compensation costs for certain individuals give rise to the need for special consideration. Such individuals include:

(A) Owners of closely held corporations, members of limited liability companies, partners, sole proprietors, or members of their immediate families; and

(B) Persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise.

(ii) For these individuals, compensation must—

(A) Be reasonable for the personal services rendered; and

(B) Not be a distribution of profits (which is not an allowable contract cost).

(iii) For owners of closely held companies, compensation in excess of the costs that are deductible as

compensation under the Internal Revenue Code (26 U.S.C.) and regulations under it is unallowable.

(b) Reasonableness—(1) Compensation pursuant to labor-management agreements. If costs of compensation established under "arm's length" labor-management agreements negotiated under the terms of the Federal Labor Relations Act or similar state statutes are otherwise allowable, the costs are reasonable unless, as applied to work in performing Government contracts, the costs are unwarranted by the character and circumstances of the work or discriminatory against the Government. The application of the provisions of a labor-management agreement designed to apply to a given set of circumstances and conditions of employment (*e.g.*, work involving extremely hazardous activities or work not requiring recurrent use of overtime) is unwarranted when applied to a Government contract involving significantly different circumstances and conditions of employment (*e.g.*, work involving less hazardous activities or work continually requiring use of overtime). It is discriminatory against the Government if it results in employee compensation (in whatever form or name) in excess of that being paid for similar non-Government work under comparable circumstances.

(2) Compensation not covered by labor-management agreements. Compensation for each employee or job class of employees must be reasonable for the work performed. Compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. In determining the reasonableness of total compensation, consider only allowable individual elements of compensation. In addition to the provisions of 31.201-3, in testing the reasonableness of compensation for particular employees or job classes of employees, consider factors determined to be relevant by the contracting officer. Factors that may be relevant include, but are not limited to, conformity with compensation practices of other firms-

- (i) Of the same size;
- (ii) In the same industry;
- (iii) In the same geographic area; and
- (iv) Engaged in similar non-Government work under comparable circumstances.

(c) [Reserved]

(d) Form of payment. (1) Compensation for personal services includes compensation paid or to be

paid in the future to employees in the form of—

- (i) Cash;
- (ii) Corporate securities, such as stocks, bonds, and other financial instruments (see paragraph (d)(2) of this subsection regarding valuation); or
- (iii) Other assets, products, or services.

(2) When compensation is paid with securities of the contractor or of an affiliate, the following additional restrictions apply:

- (i) Valuation placed on the securities is the fair market value on the first date the number of shares awarded is known, determined upon the most objective basis available.
- (ii) Accruals for the cost of securities before issuing the securities to the employees are subject to adjustment according to the possibilities that the employees will not receive the securities and that their interest in the accruals will be forfeited.

(e) Income tax differential pay.

(1) Differential allowances for additional income taxes resulting from foreign assignments are allowable.

(2) Differential allowances for additional income taxes resulting from domestic assignments are unallowable. (However, payments for increased employee income or Federal Insurance Contributions Act taxes incident to allowable reimbursed relocation costs are allowable under 31.205–35(a)(10).)

(f) Bonuses and incentive compensation. (1) Bonuses and incentive compensation are allowable provided the—(i) Awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment; and (ii) Basis for the award is supported.

(2) When the bonus and incentive compensation payments are deferred, the costs are subject to the requirements of paragraphs (f)(1) and (k) of this subsection.

(g) *Severance pay*. (1) Severance pay is a payment in addition to regular salaries and wages by contractors to workers whose employment is being involuntarily terminated. Payments for early retirement incentive plans are covered in paragraph (j)(7) of this subsection.

(2) Severance pay is allowable only to the extent that, in each case, it is required by—

- (i) Law;
- (ii) Employer-employee agreement;
- (iii) Established policy that constitutes, in effect, an implied agreement on the contractor's part; or

(iv) Circumstances of the particular employment.

(3) Payments made in the event of employment with a replacement contractor where continuity of employment with credit for prior length of service is preserved under substantially equal conditions of

employment, or continued employment by the contractor at another facility, subsidiary, affiliate, or parent company of the contractor are not severance pay and are unallowable.

(4) Actual normal turnover severance payments shall be allocated to all work performed in the contractor's plant. However, if the contractor uses the accrual method to account for normal turnover severance payments, that method will be acceptable if the amount of the accrual is—

- (i) Reasonable in light of payments actually made for normal severances over a representative past period; and
- (ii) Allocated to all work performed in the contractor's plant.

(5) Abnormal or mass severance pay is of such a conjectural nature that accruals for this purpose are not allowable. However, the Government recognizes its obligation to participate, to the extent of its fair share, in any specific payment. Thus, the Government will consider allowability on a case-by-case basis.

(6) Under 10 U.S.C. 2324(e)(1)(M) and 41 U.S.C. 256(e)(1)(M), the costs of severance payments to foreign nationals employed under a service contract performed outside the United States are unallowable to the extent that such payments exceed amounts typically paid to employees providing similar services in the same industry in the United States. Further, under 10 U.S.C. 2324(e)(1)(N) and 41 U.S.C. 256(e)(1)(N), all such costs of severance payments that are otherwise allowable are unallowable if the termination of employment of the foreign national is the result of the closing of, or the curtailment of activities at, a United States facility in that country at the request of the government of that country; this does not apply if the closing of a facility or curtailment of activities is made pursuant to a status-of-forces or other country-to-country agreement entered into with the government of that country before November 29, 1989. 10 U.S.C. 2324(e)(3) and 41 U.S.C. 256(e)(2) permit the head of the agency to waive these cost allowability limitations under certain circumstances (see 37.113 and the solicitation provision at 52.237-8).

(h) *Backpay*. Backpay is a retroactive adjustment of prior years' salaries or wages. Backpay is unallowable except as follows:

(1) Payments to employees resulting from underpaid work actually performed are allowable, if required by a negotiated settlement, order, or court decree.

(2) Payments to union employees for the difference in their past and current wage rates for working without a contract or labor agreement during labor management negotiation are allowable.

(3) Payments to nonunion employees based upon results of union agreement negotiation are allowable only if—

- (i) A formal agreement or understanding exists between management and the employees concerning these payments; or
- (ii) An established policy or practice exists and is followed by the contractor so consistently as to imply, in effect, an agreement to make such payments.

[DCAA HQ NOTE: The remainder of FAR 31.205-6 is unchanged from the current version.]