

Reasonable (or Unreasonable) Compensation

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I. INTRODUCTION

Closely held corporations pay compensation to employee-shareholders instead of dividends because compensation is deductible, while dividends are not. In an Internal Revenue Service audit of a corporation, the examiner will often disallow a portion of the compensation deduction on the grounds that it was unreasonably excessive, treating the excess as a nondeductible dividend.

Since 2001, the impact of such an adjustment has not been of much concern because dividends have been taxed to individuals at a 15-percent rate (versus compensation taxed at a maximum 35-percent rate), and dividend distributions are not subject to employment taxes. As a result, if the IRS disallows part of a corporation's deduction for compensation on the grounds that it was excessive, the net tax effect, after taking into account the resulting refunds of employment tax and the employee-shareholder's income tax, is about 12 percent.²

However, with the 15-percent tax rate on dividends due to expire on December 31, 2010, and with the possibility that such dividends may be taxed to individuals at a rate as high as 39.6 percent, it is likely that the IRS will increase its audits of corporations to raise the reasonable compensation issue for years after 2010. Practitioners need to know how to defend against the IRS claim that the compensation paid to the employee-shareholders was unreasonable.

II. LAW APPLICABLE TO REASONABLE COMPENSATION

Section 162(a)(1) of the Internal Revenue Code (IRC) permits a taxpayer to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." A taxpayer may take a deduction for compensation only if (1) the payments were reasonable in amount, and (2) the payments were for services actually rendered.³

Whether the compensation paid by a corporation to an employee-shareholder is reasonable in amount is a question of fact.⁴ Numerous factors have been used to determine the reasonableness of compensation, with no single factor being dispositive. These factors include, but are not limited to (1) the employee's qualifications, (2) the nature, extent, and scope of the employee's work, (3) the size and complexities of the business (4) the prevailing general economic conditions,

(5) a comparison of salaries paid with the gross income and the net income of the business (6) comparison of salaries with distributions to stockholders (7) the prevailing rates of compensation for comparable positions in comparable concerns (8) the salary policy of the corporation as to all employees, and (9) in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years.⁵

However, for a corporation whose principal place of business is located in California, any court considering the reasonable compensation issue would be required to follow the precedents of the Court of Appeals for the Ninth Circuit in accordance with the so-called *Golsen* Rule.⁶ The leading Ninth Circuit precedent on this issue is *Elliotts, Inc. v. Commissioner*.⁷

To determine whether compensation was reasonable, the court in *Elliotts, Inc. v. Commissioner* held that the following five factors should be considered: (1) the employee's role in the company; (2) a comparison of the compensation paid to the employee with the compensation paid to similarly situated employees in similar companies (external comparison); (3) the character and condition of the company; (4) whether a conflict of interest exists that might permit the company to disguise dividend payments as deductible compensation; and (5) whether the compensation was paid pursuant to a structured, formal, and consistently applied program.⁸ No single factor is dispositive, and the factors are not necessarily of equal weight.⁹

III. THE FIVE FACTORS OF ELLIOTTS, INC.

A. Employee's Role in the Company

The relevant considerations in applying this factor include the employee's position, hours worked, and duties performed, as well as the general importance of the employee to the success of the company.¹⁰ If the employee has received a large salary increase, comparing past duties and salary with current responsibilities and compensation also may provide significant insights into the reasonableness of the compensation scheme.¹¹ An employee's superior qualifications, position, duties performed, hours worked, and general importance to the corporation's success may justify high compensation for his or her services.¹² As a result, it is important to gather all of the facts that support this factor and present them to the IRS.

B. External Comparison

This factor is a comparison between the employee's salary and salaries paid by similar companies for similar services.¹³ The comparison should be made on the basis of services performed. As a result, if an employee performs several roles, his or her compensation should reflect the combined salaries of the job positions performed.¹⁴

In audits involving the issue of reasonable compensation, IRS examiners are encouraged to seek assistance from an economist.¹⁵ This is because in order to compare an employee's salary to similar companies, the economist will usually obtain a report from an executive compensation database. The IRS has purchased a computer program from the Economic Research Institute (www.eri.com) called the Executive Compensation Assessor®. This computer program is a database of compensation data from publicly-traded and privately-held corporations. It is the largest available database of executive wage, salary, incentive, and benefit data involving for-profit organizations.

The Executive Compensation Assessor® produces a report called "Maximum Reasonable Compensation Estimate." This report shows, as of a particular date, the maximum reasonable base salary, bonus, and other compensation paid to executives of companies of similar size and geographic location involved in the same industry as the particular corporation in question. The maximum reasonable compensation shown in this report is calculated at the 90th percentile.

According to the methodology notes for the Executive Compensation Assessor®, this report was specifically designed at the behest of the IRS to produce an amount that is defensible as the upper threshold of deductible compensation. Nevertheless, some IRS examiners do not use this report. Instead, they might allow compensation shown in other reports produced by the Executive Compensation Assessor, such as "Individual Position Profile" reports, or might determine that compensation paid at the mean or median level (50th percentile) is reasonable, or might obtain data from other sources such as the United States Department of Labor, Bureau of Labor Statistics, instead of the Executive Compensation Assessor.

In addition to base salary and bonus, the "Maximum Reasonable Compensation Estimate" report includes amounts for such items as stock appreciation rights, restricted stock awards, option awards, long-term compensation, and other compensation. Some examiners will conclude that only the amounts shown as base salary and bonus reflect reasonable compensation, and will disregard the other amounts of compensation shown in the report. Even if the corporation in question has paid only base salary and bonus to the employee-shareholder, the other types of

compensation shown in the report should be included in order to determine whether the compensation was reasonable.¹⁶

C. Character and Condition of the Company

This factor focuses on the company's size as indicated by its sales, net income, or capital value, but the complexities of the business and general economic conditions are also relevant.¹⁷ If the company's size and success is largely attributable to the employee-shareholder's efforts, especially if the particular industry or general economic conditions have been poor, this is an important fact to point out.

D. Conflict of Interest

This factor focuses on whether a relationship exists between the corporation and its employee-shareholder which might permit the corporation to disguise nondeductible dividend distributions as deductible compensation. Close scrutiny may be used when the paying corporation is controlled by the compensated employee-shareholder.¹⁸

In *Elliotts, Inc. v. Commissioner*, Mr. Elliott was the sole shareholder. The Ninth Circuit Court of Appeals stated that this was the sort of relationship that warranted scrutiny. However, the court also stated that the mere existence of such a relationship, when coupled with an absence of dividend payments, does not necessarily lead to the conclusion that the amount of compensation is unreasonably high, and that further exploration of the situation is necessary.¹⁹

The Ninth Circuit stated that it is appropriate to evaluate the compensation payments from the perspective of a "hypothetical independent investor."²⁰ Under the independent investor test, a company's annual return on equity is calculated as its net income after taxes for that year divided by the total stockholder's equity at the end of the year.²¹ If the company's return on equity after payment of the compensation at issue remains at a level that would satisfy a hypothetical independent investor, there is a strong indication that the employee is providing compensable services and that profits are not being siphoned out of the company disguised as salary.²²

What if the corporation's return on equity is at a level that would *not* satisfy an independent investor, or is even a negative number? In such a circumstance, how do you determine what portion of the compensation is reasonable? A recent case has answered this. In *Multi-Pak Corporation v. Commissioner*,²³ the corporation's return on equity for one of the years at issue was a negative 15.8 percent. The Tax Court determined that an independent investor would be satisfied at a positive 10 percent return on equity, and to achieve this level, the Court disallowed a portion of the compensation deduction in order to raise the return on

equity from a negative 15.8 percent to a positive 10 percent.

Frequently, IRS examiners will focus on the fact that the corporation has never paid any dividends to its shareholders. The Ninth Circuit in *Elliott, Inc. v. Commissioner* addressed this by stating that the Tax Court erred by limiting its analysis to the facts that Mr. Elliott was the corporation's sole shareholder and that the corporation paid no dividends. The court stated that these are relevant factors, but they cannot be viewed in isolation.²⁴ The court said that the corporation's no-dividend policy did not, by itself, demonstrate that the relationship between the corporation and Mr. Elliott was being exploited. Accordingly, the fact that a corporation has never paid any dividends is not a fatal factor.

E. Compensation Pursuant to a Structured, Formal, and Consistently Applied Program

This factor focuses upon whether there is evidence of an internal inconsistency in a company's treatment of payments to employees because such evidence may indicate that the payments go beyond reasonable compensation. Bonuses that have not been awarded under a structured, formal, consistently applied program generally are suspect. On the other hand, evidence of a reasonable, longstanding, consistently applied compensation plan is evidence that the compensation paid in the years in question was reasonable.²⁵

Incentive payment plans are designed to encourage and compensate the extra effort and dedication which can be so valuable to a corporation, so there is no reason an employee-shareholder should not also be entitled to such compensation if his or her dedication and efforts are instrumental to the corporation's success. If an outside investor would approve of such a compensation plan, that plan is probably reasonable.²⁶

The fact that employee-shareholders might be compensated more highly than other employees is not necessarily a negative factor. The Tax Court has ruled that if the employee-shareholder was compensated more highly than the other employees because the company's profits were derived almost exclusively through his or her all-encompassing, far-reaching efforts, and if the other employees had limited roles in that profitability, and if a hypothetical independent investor would view the employee-shareholder's compensation as reasonable, then this factor favors the corporation.²⁷

IV. ADDITIONAL POINTS TO CONSIDER

Three additional points deserve discussion: (1) past undercompensation, (2) *Menard, Inc. v. Commissioner*, and (3) the accuracy-related penalty.

A. Past Undercompensation

Quite often, corporations might forgo paying compensation to an employee-shareholder until it has become more profitable. As a result, an employee-shareholder might be under-compensated in prior years and therefore, the compensation paid in the current year might be intended to make up for under-compensation that existed in prior years. In order to be allowed the deduction, the taxpayer must show that (1) the employee was undercompensated in prior years, and (2) the compensation paid in the current year was intended as compensation for prior years' services.²⁸ Testimony may be used to establish these elements.²⁹

Care should be taken in making this argument because if the compensation was for years in which the corporation operated as a different entity, such as a sole proprietorship, partnership, or limited liability company, the compensation isn't generally deductible. Most courts have held that compensation paid by a corporation for services rendered before the date that the business incorporated is not deductible.³⁰

B. *Menard, Inc. v. Commissioner*

In 2009, the Court of Appeals for the Seventh Circuit decided *Menard, Inc. v. Commissioner*.³¹ This was a significant loss for the IRS because of the large numbers involved, and if the facts of your situation are similar to this case, citing this case might convince the IRS that the compensation paid was reasonable.

In *Menard, Inc. v. Commissioner*, John Menard was founder, CEO, and 89-percent shareholder of Menard Inc., a closely held corporation that operated a retail home improvement chain. The corporation paid Mr. Menard compensation totaling \$20,642,485, which included a 5 percent year-end bonus of \$17,467,800. The IRS disallowed \$19,261,609 of the compensation on the grounds that it was unreasonable. The Tax Court allowed a deduction for \$7,066,912, and the corporation appealed. The Seventh Circuit reversed the Tax Court.

The Seventh Circuit pointed out that Menard, Inc. was the third largest retail home improvement chain in the United States, and that only Home Depot and Lowe's were larger. Mr. Menard was its founder and chief executive. He worked 12 to 16 hours a day, six or seven days a week, took only seven days of vacation a year, and worked even while he was spending time with his family. He involved himself in every detail of the company's operations. Under his management, the company's revenues grew from \$788 million in 1991 to \$3.4 billion in 1998, a four-fold increase in seven years. The company's rate of return on shareholder equity during the year in issue was 18.8 percent, which was higher than that of either Home Depot or Lowe's.

Despite the fact that the company paid no dividends, the Seventh Circuit determined that the entire \$20,642,485 in compensation was reasonable.

C. Accuracy-Related Penalty

In many instances, the examiner will impose the 20-percent accuracy-related penalty under IRC section 6662 based on "substantial understatement." There is an important way that this penalty might be avoided.

In relevant part, the Code provides for a 20-percent penalty for the portion of the underpayment that is due to a substantial understatement of tax.³² For a corporation, a substantial understatement of tax is defined as an understatement that exceeds the greater of 10 percent of the tax required to be shown on the return, or \$10,000.³³ These thresholds are usually exceeded in a reasonable compensation case. For purposes of computing the penalty, the amount of the understatement is reduced for any items that have been adequately disclosed in the return and for which there is a reasonable basis for the tax treatment.³⁴

The IRS has issued several Revenue Procedures listing the circumstances under which disclosure will be deemed to be adequate if the taxpayer has completed certain portions of the tax return. Disclosure is deemed to be adequate for the reasonableness of a deduction claimed for compensation of officers if the taxpayer has completed Form 1120, Schedule E, and the time devoted to business is expressed as a percentage as opposed to "part" or "as needed."³⁵ Most corporations have completed this section of the return in accordance with the Revenue Procedure, and as a result, might be able to avoid the penalty on the grounds that the compensation was adequately disclosed.

V. CONCLUSION

If the IRS increases its audits of compensation paid to employee-shareholders of closely held corporations, you will need the proper tools to defend your clients against proposed audit adjustments in this area. Hopefully, this article gives you some of these tools.

ENDNOTES

1. David M. Fogel is a self-employed non-attorney tax consultant and an associate member of the Taxation Section of the State Bar of California and the Taxation Section of the Sacramento County Bar. He represents clients in tax controversy matters before the various tax authorities. He also provides tax research and consulting services to other tax practitioners. David has more than 36 years of experience in tax controversies, including 26 years working for the IRS (eight years as a Tax Auditor and Revenue Agent, 18 years as an Appeals Officer), and six years as a tax

advisor for two Sacramento law firms. He has authored more than 50 articles on a variety of technical tax issues. David is a Certified Public Accountant, an Enrolled Agent, and is also admitted to practice before the United States Tax Court. He can be reached at dfogel@surewest.net or on the Internet at <http://fogelcpa.com>.

2. Assuming a maximum corporate income tax rate of 35 percent, the corporation would be able to recoup at least the Medicare portion of employment taxes (2.9 percent), and the employee-shareholder would be able to obtain an income tax refund for the difference between the tax rate on compensation (maximum 35 percent) and the tax rate on dividends (15 percent). Thus, the net tax change would be 12.1 percent (35 percent – 2.9 percent – 20 percent), and this does not even take into consideration refunds of California employment taxes that might be available.

3. Treas. Reg. § 1.162-7(a); *Nor-Cal Adjusters v. Comm'r*, 503 F.2d 359, 362 (9th Cir. 1974), affg. T.C. Memo. 1971-200.

4. *Owensby & Kritikos, Inc. v. Comm'r*, 819 F.2d 1315, 1323 (5th Cir. 1987), affg. T.C. Memo. 1985-267; *Charles Schneider & Co. v. Comm'r*, 500 F.2d 148, 151 (8th Cir. 1974), affg. T.C. Memo. 1973-130.

5. See *Mayson Mfg. Co. v. Comm'r*, 178 F.2d 115, 119 (6th Cir. 1949); *Rapco, Inc. v. Comm'r*, 85 F.3d 950, 954 (2d Cir. 1996), affg. T.C. Memo. 1995-128; *Owensby & Kritikos, Inc. v. Comm'r*, 819 F.2d at 1323; *Pepsi-Cola Bottling Co. v. Comm'r*, 528 F.2d 176, 178 (10th Cir. 1975), affg. 61 T.C. 564 (1974).

6. *Golsen v. Comm'r*, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971).

7. *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241, 1245 (9th Cir. 1983), revg. T.C. Memo. 1980-282.

8. *Id.*, at 1245-1248; see *LabelGraphics, Inc. v. Comm'r*, T.C. Memo. 1998-343, affd. 221 F.3d 1091 (9th Cir. 2000).

9. *Elliotts, Inc. v. Comm'r*, 716 F.2d at 1245; see *Pacific Grains, Inc. v. Comm'r*, 399 F.2d 603, 606 (9th Cir. 1968).

10. *Elliotts, Inc. v. Comm'r*, 716 F.2d at 1245.

11. *Id.*

12. See *Charles Schneider & Co. v. Comm'r*, 500 F.2d at 152; *Wagner Construction, Inc. v. Comm'r*, T.C. Memo. 2001-160.

13. *Elliotts, Inc. v. Comm'r*, 716 F.2d at 1246.

14. *Id.* ("If Elliott was performing the work of three people, the relevant comparison would be the combined salaries of those three people at another dealer."); see *John L. Ginger Masonry, Inc. v. Comm'r*, T.C. Memo. 1997-251 ("[John L.] Ginger effectively performed the roles of chief executive officer, chief financial officer, chief operations/administrative officer, and marketing executive. Ginger's compensation should reflect the combined salaries of the job positions he performed.")

15. See section 4.49.1.1 of the Internal Revenue Manual.

16. For example, in *Beiner, Inc. v. Commissioner*, T.C. Memo. 2004-219, the corporation's expert testified that reasonable compensation should include salary, reasonable incentive (bonus), and "excess gross profits." The IRS objected and argued that because the corporation paid Mr. Beiner only salary and bonus, no amount should be allowed for "excess gross profits." The Tax Court rejected the IRS's argument.
17. *Elliotts, Inc. v. Comm'r*, 716 F.2d at 1246.
18. *Id.*
19. *Id.*
20. *Id.*, at 1247.
21. *Id.*; see *Dexsil Corp. v. Comm'r*, 147 F.3d 96, 99 (2d Cir. 1998), vacating T.C. Memo. 1995-135; *Labelgraphics, Inc. v. Comm'r*, T.C. Memo. 1998-343, affd. 221 F.3d 1091 (9th Cir. 2000).
22. *Elliotts, Inc. v. Comm'r*, 716 F.2d at 1247.
23. *Multi-Pak Corp. v. Comm'r*, T.C. Memo. 2010-139.
24. *Elliotts, Inc. v. Comm'r*, 716 F.2d at 1246.
25. *Id.*, at 1247.
26. *Id.*, at 1248.
27. See *Beiner, Inc. v. Comm'r*, T.C. Memo. 2004-219.
28. See *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115, 119 (1930); *Pacific Grains, Inc. v. Comm'r*, 399 F.2d at 606; *Estate of Wallace v. Comm'r*, 95 T.C. 525, 556 (1990), affd. 965 F.2d 1038 (11th Cir. 1992); *Haffner's Service Stations, Inc. v. Comm'r*, T.C. Memo. 2002-38; *Wagner Construction, Inc. v. Comm'r*, T.C. Memo. 2001-160.
29. *Devine Bros., Inc. v. Comm'r*, T.C. Memo. 2003-15.
30. *Young v. Comm'r*, 650 F.2d 1083 (9th Cir. 1981); *U.S. Asiatic Co. v. Comm'r*, 30 T.C. 1373 (1958); *Bianchi v. Comm'r*, 66 T.C. 324 (1976), affd. per curiam 553 F.2d 93 (2d Cir. 1977); *LaMastro v. Comm'r*, 72 T.C. 377 (1979).
31. *Menard, Inc. v. Comm'r*, 560 F.3d 620 (7th Cir. 2009), revg. T.C. Memo. 2004-207.
32. IRC §§ 6662(a), 6662(b)(2).
33. IRC § 6662(d)(1)(B).
34. IRC § 6662(d)(2)(B)(ii).
35. See section 4.02(2)(d) of Revenue Procedure 2010-15, 2010-7 I.R.B. 404, which is applicable to 2009 returns. This section of the Revenue Procedure does not apply to "golden parachute" payments as defined under IRC section 280G, or to the extent that compensation exceeds the \$1 million limitation of IRC section 162(m)(1) for certain employees of publicly-held corporations.