The Scrutiny of Executive Compensation

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The reasonableness of shareholder/employee compensation in a closely held corporation is an important, and often controversial, issue for income tax purposes. Sometimes, owner/executive compensation may be disguised as a management fee, consulting fee, bonus, or "catch-up" payment. In whatever form the executive compensation is reported, closely held company owners often rely on valuation analysts to help them estimate a reasonable level of executive compensation in order to minimize the risk of being audited by the Internal Revenue Service. This discussion (1) reviews federal statutes and judicial precedent regarding reasonable compensation and (2) summarizes some of the owner/executive compensation issues from recent judicial decisions.

Introduction

Internal Revenue Code Section 162(a) allows expenses incurred or paid by a business in a taxable year that include reasonable compensation for services rendered to be deducted for U.S. federal income tax purposes.

If the business is a closely held corporation and the persons receiving the compensation are shareholders, the payments (which may include a salary, bonus, or other compensation paid to shareholder employees) may be subject to close scrutiny by the Internal Revenue Service (the "Service").

The Service may want to determine if the expense represents:

1. market based compensation for services rendered or
2. a disguised distribution of profits to shareholders.

There can be significant tax-related consequences associated with unreasonable shareholder/employee compensation.

In some cases where the shareholder(s) owns several related businesses, the executive compensation is presented in the form of a management fee that one entity charges to another related entity for consulting services provided by the shareholder(s).

This form of compensation issue arose in the case of *F-Star Property Management, Inc. v. Commissioner*.[1] In that decision, the Service disallowed some of the deduction for management fees comprised of compensation paid to the sole shareholder of the corporation. This issue also arose in the case in *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*.[2] In that decision, the court disallowed a deduction for consulting fees paid indirectly to the founding shareholders, in addition to their salary.

Whether executive pay is reported as compensation expense, or disguised as a management fee, consulting fee, bonus, or "catch-up" payment paid to shareholder employees, to minimize the risk of being audited by the Service, closely held company owners often rely on analysts to help them estimate a reasonable level of executive compensation.

This discussion presents the following:

1. The guidance from the federal tax statutes and judicial precedent on reasonable compensation
2. A review of the judicial decisions in the *F-Star Property Management* case and the *Mulcahy, Pauritsch, Salvador* case regarding compensation from related entities
3. Other owner/executive compensation issues discussed in recent judicial decisions

Reasonable Compensation Guidance

Compensation paid to shareholder executives is often scrutinized by the Service. Shareholder executives of closely held C corporations have an incentive to pay themselves higher salaries in order to avoid paying federal income taxes on the operating profit of the C corporations. Additionally, the Service often claims that excess compensation represents a disguised nondeductible dividend to the shareholder.

Section 162(a) provides that executive compensation is deductible as a business expense if it is (1) reasonable in amount and (2) based on services actually rendered.[3]

For shareholder/executive compensation to qualify as employee compensation, Treasury Regulation 1.162.7 lists the following four requirements. Shareholder/executive compensation should be:

1. an ordinary and necessary expense,
2. reasonable in amount,
3. based on services actually rendered, and
4. actually paid or incurred by the taxpayer corporation.[4]

Also according to Regulation 1.162-7, a taxpayer corporation may deduct a shareholder compensation payment that is based on performance using a percentage formula. Shareholder compensation based on the percentage formula may be:

1. a percent of corporation revenue,
2. a percent of corporation earnings, or
3. a percent of some of corporation income measure.

In addition to federal regulations on executive compensation, companies can also review judicial precedents to determine the reasonableness of executive compensation. Factors to consider in determining the reasonableness of an executive compensation were first presented by the Tax Court 65 years ago in the *Mayson Manufacturing Company v. Commissioner* decision.[5]

The *Mayson* decision listed eight factors that should be evaluated in determining the reasonableness of compensation paid to a shareholder executive.

In 1996, the Tax Court expanded the *Mayson* factors in *Pulsar Components International, Inc. v. Commissioner*,[6] to include the following:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's work
3. The size and complexities of the employer's business
4. A comparison of salaries paid with the employer's gross and net income
5. The prevailing general economic conditions and the background of the industry
6. A comparison of salaries with distributions to officers and retained earnings and the employer's dividend history
7. The prevailing rates of compensation for comparable positions in comparable concerns
8. The salary policy of the employer as to all employees
9. The amount of compensation paid to the particular employee in previous years
10. The employer's financial condition
11. Whether the employer and employee dealt at arm's length
12. Whether the employee guaranteed the employer's debt
13. Whether the employer offered a pension plan or profit-sharing plan to its employees
14. Whether the employee was reimbursed by the employer for business expenses that the employee paid personally

In the *Trucks, Inc. v. U.S.* decision,[7] some of the factors considered regarding the shareholder employee in determining the reasonableness of executive compensation, included the following:

1. Training and qualifications
2. Responsibilities and number of hours worked
3. Results of employee's efforts
4. Ratio of compensation to company growth (before salaries and tax)
5. Absence of fringe benefits available to executives in comparable companies
6. Responsibility for inception and/or success
7. Correlation between compensation and ownership interest

Additionally, the federal courts have increasingly relied on the independent investor test in reasonable compensation disputes. The Tax Court first illustrated the independent investor test in 1984 in the *Elliotts, Inc. v. Commissioner*[8] decision.

In the independent investor test, the Tax Court considered whether an independent investor would pay the shareholder executive the same

compensation he/she was receiving from the company.

The court based its independent investor consideration on the actual rate of return on owner's equity for the subject company compared to a market-derived required rate of return on owner's equity.

The following discussion summarizes judicial decisions relating to:

1. shareholder employee compensation from related entities in the form of a management or consulting fee and
2. other shareholder executive compensation issues from recent court rulings.

Compensation from Related Entities

F-Star Property Management

In *F-Star Property Management, Inc. v. Commissioner*, the court considered the issue of shareholder executive compensation reported as a management fee.

Gerald Ayoub owns a group of related entities collectively known as Five Star Development. Five Star Development purchases land, develops the land into commercial warehouses or retail space, and leases and manages the retail space.

Included in Five Star Development are the following entities:

1. F-Star Property Management, Inc. ("F-Star Management")
2. F-Star Management, LLC, a disregarded entity for tax purposes
3. F-Star Development, L.P., a limited partnership
4. The developed real property limited partnerships

A C corporation located in Scottsdale, Arizona, F-Star Management operates and manages over seven million square feet of commercial rental real estate.

Ayoub owns 100 percent of F-Star Management, 99 percent of F-Star Development, and 99 percent of the developed real property limited partnerships. F-Star Management owns 1 percent of F-Star Development and 1 percent of the developed real property limited partnerships.

F-Star Management (i.e., Ayoub) manages the developed properties. Ayoub is the chief executive officer (CEO) of F-Star Management.

In 2004 and 2005, F-Star Management paid $1,146,279 and $1,197,957, respectively, to Ayoub in the form of a management fee for consulting services rendered. F-Star Management reported taxable income of zero in its 2004 income tax returns and a loss in its 2005 income tax returns.

Upon review of the general ledger of F-Star Management, the Service could not determine how the management fees were paid out. Further, the Service could not reconcile the employee leasing expense on the income tax returns of the development company and the management company.

F-Star Management charges a 4.5 percent monthly management fee on the rent it collects from all the commercial rental properties that it manages for Ayoub. It then pays Ayoub as CEO the 4.5 percent management fee for services Ayoub provided to F-Star Management.

In addition, F-Star Management also employs various other employees to conduct business operations at the corporate headquarters in El Paso, Texas, and Scottsdale, Arizona.

Ayoub's representative described Ayoub's job responsibilities as:

> owner and CEO of the group of companies known as Five Star Development. Ayoub is involved in all aspects of each company within the group. His duties consist of development of investment (real estate) opportunities, review and supervision of day to day operations, coordination of company financial activities, negotiation of business points on contracts, leasing of various buildings and overall supervision of construction projects.[9]

In addition, Ayoub owns 42 percent of Southwest Food Processing and Refrigeration Services, Inc., which paid Ayoub a salary of $186,333 in 2004 and $44,500 in 2005.

The Service argued that the management fees paid to Ayoub in 2004 and 2005 cannot be deductible expenses based on the following reasons:

- Ayoub is the sole shareholder of F-Star Management. Instead of being paid a reasonable salary as a corporate officer, F-Star Management paid Ayoub a management fee.
- F-Star Management asserted that it operates and manages commercial rental real estate. Yet, it described the services provided by Ayoub as the "development of investment (real estate) opportunities," a service that F-Star Management does not provide.

- F-Star Management did not have a formal contract or any documentation to support the payments made to Ayoub. Further, the Service argued that there was no documentation to show how the management fees paid to Ayoub were determined.
- Ayoub as CEO should not receive the 4.5 percent management fee that F-Star Management charged to its rental properties since F-Star Management already employs various employees to manage the properties.

However, the Service did allow a portion of the management fee to be paid as a reasonable salary for Ayoub and reclassified the rest of the management fee as a distribution of profits.

Based on the median salary of a top commercial real estate executive in Phoenix, Arizona, published on Salary.com, the Service determined that a reasonable salary for Ayoub was $200,468.

Since Ayoub already received a salary of $186,333 in 2004 from Southwest Food Processing and Refrigeration Services, Inc., a related entity, the Service allowed the deduction of $14,135 as an additional expense for a total salary of $200,468 for Ayoub.

The Service allowed the deduction of $155,968 for a total salary of $200,468 for Ayoub in 2005 since he already received $44,500 from Southwest Food Processing and Refrigeration Services, Inc.

On November 10, 2008, F-Star Management filed a petition with the U.S. Tax Court. Around January 14, 2009, the F-Star Development case was referred to the Appeals Court for consideration.

Based on the personal income tax returns of Mr. and Mrs. Ayoub, the Ayoubs reported receiving $916,850 of the $1,146,279 accrued management fee in 2004 and $586,503 of the $1,197,957 accrued fee for 2005. Given Ayoub's experience and involvement in the many real estate ventures of his F-Star companies, the Appeals Court believed the amounts received by Mr. and Mrs. Ayoub in 2004 and 2005 were reasonable.

Since Section 267 limits the corporate tax deduction to the amounts actually received and reported, the Appeals Court denied F-Star Management the deduction of $229,429 in 2004 and $611,454 in 2005. The Appeals Court recommended the Service partially abate the income tax deficiencies of F-Star Management in 2004 and 2005.

Section 7430(a)(1) authorizes an award to the prevailing party of reasonable administrative costs incurred in connection with an administrative proceeding with the Service.[10]

The Appeals Court then denied F-Star Management's request for administrative fees since the Service was justified in its position of denying the deduction of management fees even though the Service had partially conceded some of the deductions.

Mulcahy, Pauritsch, Salvador & Co.

Similar to *F-Star Property Management, Inc. v. Commissioner*, in *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, the court deliberated on the issue of distributions disguised as third-party consulting fees from related entities.

The company, a professional services firm, paid consulting fees to entities owned by its founding shareholders. The court held that the consulting fees were disguised nondeductible dividends, rather than deductible reasonable salaries for services actually rendered.

Independent Investor Test

The court ruled that deductible owner-employee salary and nondeductible dividend can be distinguished by comparing the corporation's reported income with that of similar corporations.[11] This comparison can be made based on a percentage return on equity.

A higher return provides stronger support that the owner-employee deserves significant credit for the company's increased profitability, which would be reflected in his salary.

The court used the independent investor test to determine the reasonableness of the salary paid to the founding shareholder employees.

An independent investor would be willing to pay a salary to an executive that is a function of:

1. the expected return he/she would demand for his/her investment and
2. the actual return on investment after all expenses, including compensation.

If paying a particular salary causes net income to fall below the investor's expected return, it is unlikely that an independent investor would approve such compensation. However, if earnings after compensation remain at a level acceptable to an investor, it is an indication that management is providing compensable services.[12]

Typically, the higher the rate of return an employee can generate, the greater the salary he/she can command.[13]

The court concluded that an independent investor would not begrudge the owner/employee his high

> **"The taxpayer should be able to explain why the owner/employee is responsible for any excess earnings of the company."**

salary if the company's return on equity is satisfactory. He/she would "consider the salary reasonable compensation of the owner's contribution to the company's success."[14] However, the company's success may also be the result of extraneous factors.

Although the company's superior performance may be the result of the owner/employee's contribution, it may also be due to:

1. favorable market conditions,
2. a competitor's failures,
3. the company's intangible assets and intellectual property, or
4. being in the right place at the right time.

The taxpayer should be able to explain why the owner/employee is responsible for any excess earnings of the company.

An independent investor may be willing to accept a lower rate of return due to the subject company's significant sales growth, stability, leverage, and the associated risk of an investment in the company's equity. An independent investor would consider whether a shareholder employee was instrumental in the financial success and stability of the company.[15]

Additionally, the company's profitability can be persuasive in an independent investor test when it can be attributed to the proven capability and efforts of the shareholder employee.

When it is possible that the company's success may be the result of other extraneous causes, other factors such as comparable salaries should be considered to determine reasonable compensation. In this particular decision, the court compared the salaries in question to those of comparable employees (employees with similar duties, responsibilities, and skills) of other companies who are not owners, or to nonowner employees of the company itself, who make comparable contributions to the company's success.

The court considered the company's general economic and financial condition, stating that "when a thriving firm that has nontrivial capital reports no corporate income, it is apparent that the firm is understating its tax liability."[16]

Additionally, because the company was a professional services firm, with revenue that is closely tied to the services performed by its employees, the court examined the number of employees at the company, its intangible and tangible capital, and its equity ownership.

Services Rendered

Additionally, the Tax Court emphasized that there should be evidence that consulting fees are compensation for actual consulting services rendered by the shareholder employees.

The owner employee's contribution of capital to the company is not considered a "personal service" for which the owner may be reimbursed by means of a deductible salary.

In this case, in addition to receiving salaries for their revenue-generating services, the shareholder employees also received consulting fees that the company paid to the entities owned by the same shareholder employees. These entities in turn passed the money on to the shareholders.

The company owners treated these consulting fees as salary, thus reducing the company's income and return to equity investors. However, based on earnings before the deduction for consulting fees, the company was performing well.

The company owners argued that the consulting fees paid to related entities were not payments for services rendered to the company by these entities. The company argued that these consulting fees represented payments for accounting and consulting services provided by the founding shareholders to the company's clients, and were in effect an additional salary.

However, the court did not find any evidence that showed the consulting fees were compensation for actual accounting and consulting services rendered by the founding shareholders. The company did not treat the consulting fees as labor expenses and did not withhold payroll taxes on them.

The amounts were not reported as employee compensation on employment forms and were not disclosed in the officers' compensation schedule in the corporate income tax returns. There was no record that matched consulting fees to work performed by each shareholder.

Ruling

The Tax Court also found that the company estimated its own tax liability and decided to classify the consulting fees as salary without seeking independent tax advice, thus, creating a conflict of interest.

The court concluded that the consulting fees were not deductible and were in effect distributions

to the shareholders. In conclusion, the court found the taxpayer liable for a statutory penalty for substantial underpayment of income taxes.

Other Judicial Guidance

Aries Communications Inc. v. Commissioner

In Aries Communications Inc. v. Commissioner,[17] the Tax Court considered the reasonableness of compensation paid to the corporation's owner/employee. In particular, the court considered the appropriateness of a sales bonus and "catch-up" payments made to the owner as part of his compensation.

The owner/employee was the corporation's president, chief financial officer (CFO), and sole shareholder from its incorporation. He was actively involved in the day-to-day operations of the corporation.

Additionally, when the corporation was seeking to sell some of its assets, the owner referred potential purchasers for the sale of two of its radio stations, and was personally involved in garnering the first bids and subsequent negotiations.

The owner's compensation package included a base salary, commissions, and two significant bonuses made in the years of the two asset sales. The compensation package included payments for previously uncompensated work and a bonus based on the substantial income he generated from the sale of the two radio stations.

The Tax Court considered the reasonableness of the compensation, and in particular, the bonuses, in light of the following five factors:

1. Employee's role in the company
2. Comparison of employee's salary with salaries paid by similar companies for similar services
3. Character and condition of the company
4. Potential conflicts of interest
5. Internal consistency

The court also considered whether an independent investor would be willing to compensate the employee as the taxpayer did.

Owner's Role

To assess the reasonableness of his compensation, the Tax Court considered the company's reliance on the owner/employee. Other relevant considerations included his position, hours worked, and duties performed, as well as tenure and experience in the industry. The owner was the most valuable employee of the company. Additionally, the owner provided a personal guarantee for company debt.

The court considered the argument that the owner employee was entitled to a bonus for the asset sales, which he "masterminded" and facilitated.

In some circumstances, "the value of an outstanding achievement cannot readily be quantified."[18] Experts that testified disagreed on how to quantify the owner's contribution to the sale of assets.

With respect to the bonuses paid, the court considered the worth of the owner's services in the sale of the assets, assuming the owner acted as a consultant to improve the sale offers. Additionally, the court considered whether executive bonuses at similar companies increased in correlation to increasing receipts of the company.

The owner made the decision to both acquire and maintain the assets sold, which appreciated significantly. The court considered whether he:

1. invested in the assets personally as a passive owner/investor or
2. made the investment choices as a moneymaking strategy in his capacity as the chief executive officer.

Had he personally purchased the assets and then transferred them to the corporate entity, the deduction of compensation, or bonus, for the sale of such assets would be disallowed.

However, the assets were acquired by the company, and the decisions of the owner were treated as the decisions of the CEO of the company. The owner in his executive capacity played a pivotal role in the acquisition, management, and profitable sale of the company's major assets. His efforts over the years allowed the company to capitalize on this business opportunity.

The Tax Court argued that the owner had significant interest in garnering the highest price for the assets in order to receive the reward in the form of a salary deductible by the corporation, rather than as a nondeductible dividend.

The court determined that despite this fact, his efforts as an employee were still entitled to a reasonable compensation for the services actually rendered. Given his dual status as a shareholder and CEO, he would in all events be motivated to obtain the highest sale price.

Catch-up Pay

The Tax Court also considered the taxpayer's claim that the owner's compensation was reasonable

because it included catch-up payments for prior years in which the owner was undercompensated.

Occasionally, the compensation in dispute may include deferred compensation that was paid years after it was earned. "Catch-up pay is especially common when start-ups cannot pay the founders the full value of their services because of limited cash flow[,] yet these early years may be when the owners worked the hardest."[19]

Companies may not have the resources to pay shareholder employees reasonable compensation in growth years, as they may be generating lower margins or retaining capital for corporate investment.

Once the company determines that it can sustain a higher reasonable level of compensation, they may award higher pay to retroactively remunerate the shareholder employee for lower compensation during the growth or start-up years.

In various circumstances, the Service has allowed higher than average levels of compensation to be deductible for companies that maintained records and effectively demonstrated that the shareholders were purposely awarded higher compensation to make up for past inequity.[20]

However, if the shareholder employee's past services have not been well documented and undercompensation cannot be effectively demonstrated, it may be difficult to determine whether any portion of compensation (and how much) is for actual catch-up pay.

Compensation in the years in which the shareholder claims to have been undercompensated may be compared with the compensation of comparable positions at guideline companies.

According to the court, compensation for prior years' services is deductible in the current year as long as the employee was actually undercompensated in prior years, and the current payments are intended to compensate for prior services. Based on expert witness findings, the court found that the owner's salary was below market level in prior years, and some catch-up compensation was appropriate.

Condition of the Company

In assessing the reasonableness of executive compensation, the court also analyzed the character and condition of the company. The court focused on company size, complexity, net income, and its general economic condition. The court considered the company's capital structure and its level of leverage.

The Tax Court also considered the company's ability to operate as a going concern, had the sale of its assets not occurred. The assets that were sold appreciated significantly in value since their acquisition, presumably based on the future cash flow they were expected to generate.

The court compared the actual financial performance of the company to the expected performance of the company from the effective use of these assets. The court found that the company's actual performance was below the company's expected performance using the assets.

Conflict of Interest

The court also considered any indicia of a conflict of interest. The court is concerned that when there is a relationship between an owner employee and the company, this may allow the owner employee to disguise nondeductible corporate distributions as salary expenditures.[21]

Close scrutiny is warranted when the shareholder employee has control of the corporation, serves on the board of directors, or is a trustee for the company's retirement plan.

The court determined that a relationship did exist between the corporation and the employee owner because the number of shares of common stock outstanding had changed, and this could not be reconciled with the company's retained earnings.

The change in shares outstanding would imply that some distribution to stockholders may have occurred, although there was no documentation of any dividend distributions.

However, the court ruled that "the mere existence of such a relationship, when coupled with the absence of dividend payments, does not necessarily lead to the conclusion that the amount of compensation is unreasonably high."[22]

In such case, the alleged salary payments may be closely scrutinized, and compensation may be evaluated from the perspective of a hypothetical independent investor.

The owner employee facilitated the sale of assets for prices much higher than initially offered and kept the company out of bankruptcy by paying off the company's debt with the proceeds. Similarly, an independent investor would seek the highest price for company assets and would reward any employees for their work in securing such prices.

The owner also had a "significant interest in garnering the highest price for the assets and then receiving the reward [for the sale] as salary deductible [bonus] instead of a nondeductible dividend."[23]

The court also considered other conflicts of interest that existed between the owner and the company. The corporation argued that the owner/employee's investment in and maintenance of the assets, not just his negotiation skills, contributed

to the profitable sale of the assets. The corporation argued that the owner employee should be reimbursed for this work. The court found that the owner employee was already well compensated for his work in investing in and maintaining the assets of the company, before consideration of the bonus.

Additionally, the owner/employee received significant financial benefit from the loans made to him by the company.

Internal Consistency

The court also looked at any internal consistency issues within the company, considering existing company policies regarding compensation and bonuses and how consistently these policies are applied. "Evidence of an internal inconsistency in a company's treatment of payments to employees may indicate that the payments go beyond reasonable compensation."[24]

The Service scrutinizes executive bonuses that have not been awarded under a structured, formal, and consistently applied performance bonus program. In this case, the bonuses paid to the owner employee were not paid under a structured or formal plan.

In contrast, "evidence of a reasonable, longstanding, consistently applied compensation plan is evidence that the compensation paid in the years in question is reasonable."[25]

Bonuses paid under a taxpayer's plan to award (1) additional compensation for present work or (2) reimbursement for prior years' lack of compensation once the company becomes profitable may be allowable.

With regard to the bonuses, the court considered whether the taxpayer's profits and potential federal income tax liability were known at the time the bonuses were determined. If the salary or bonus is determined at the end of the fiscal year when the company profitability is known, the shareholder employee may have an incentive to set his/her compensation at a higher level to minimize the corporate tax liability and disguise a dividend as compensation.

Additionally, the court compared the owner/employee compensation with that of other employees of the company.

Independent Investor Test

Next, the Tax Court determined the reasonableness of the compensation from the viewpoint of an independent investor. An investor would expect to receive a return on initial investment and "would not approve of a salary package that depleted the corporation's assets without paying the investor."[26]

The taxpayer claimed that owner's compensation included "catch-up" payments for prior services rendered. However, if the majority of the corporate earnings are paid out as compensation so that corporate profits after payment do not represent a reasonable return on equity, an independent investor would probably disapprove of such a compensation arrangement.

In contrast, if the earnings on equity remain at a satisfactory level to an independent investor, this would indicate that management is providing compensable services and that profits are not being taken out of the company disguised as salary.

". . . evidence of a reasonable, longstanding, consistently applied compensation plan is evidence that the compensation paid in the years in question is reasonable."

The court determined that return on investment acceptable to an independent investor was in the range of 10 to 20 percent, an indication that compensation is reasonable.[27]

Ruling

In *Aries Communications Inc. v. Commissioner*,[28] the Tax Court concluded that the owner/employee compensation was high in comparison to salaries paid by similar companies and that the owner/employee had a significant interest in garnering the highest price for the assets, in order to receive a reward in the form of a salary deductible by the corporation rather than a nondeductible dividend.

The court also found that the owner's fixed salary was underpaid and some "catch-up" compensation was appropriate. Further, the court determined that a partial bonus for the sale of assets was appropriate.

K&K Veterinary Supply, Inc. v. Commissioner

In *K&K Veterinary Supply, Inc. v. Commissioner*, the court reviewed (1) the employee's qualifications and performance and (2) the compensation of similar positions in comparable companies to determine the reasonableness of executive compensation.

The company, a wholesale distributor of animal health products, was founded by John Lipsmeyer ("J. Lipsmeyer") and Kelly Bright.

J. Lipsmeyer was the company's sole shareholder, president, and co-chief executive officer and co-chief operating officer with his brother, David Lipsmeyer ("D. Lipsmeyer"). J Lipsmeyer's wife,

Melissa Lipsmeyer ("M. Lipsmeyer") was the vice president, secretary, and assistant CFO. His daughter, Jennifer Stewart ("Stewart") was the company's CFO. J. Lipsmeyer and M. Lipsmeyer were the co-guarantors of the company's line of credit.

The company paid compensation to J. and M. Lipsmeyer as officers and to D. Lipsmeyer and Stewart as employees. Additionally, J. Lipsmeyer received a dividend of $30,000 in each of the years at issue (2006 and 2007). The Service disallowed a portion of the (1) officer's compensation paid to J. and M. Lipsmeyer and (2) salaries and wages paid to D. Lipsmeyer and Stewart.

Shareholder Employee Factors

In this case, the Tax Court considered factors such as the nature, extent, and scope of the work performed by the shareholder employee to determine if the company's success was due to the employee or the result of other extraneous factors.

The court also considered the size and complexity of the company, as well as the general economic conditions, which may affect the performance of a company. "Adverse economic conditions . . . tend to show that an employee's skill was important to a company that grew during the bad years."[29]

The court analyzed compensation as a percentage of the corporation's gross and net income to determine its reasonableness. The court reasoned that higher percentages may be warranted if:

1. the shareholder executives are exceptionally qualified by virtue of education, training, experience, dedication, and have been undercompensated in previous years;
2. the shareholders' training, experience, and dedication was the primary reason for the company's growth and success;
3. the shareholder executives' services led to the company's success; or
4. evidence exists that profits are attributable to the shareholder executives.[30]

Internal Comparison

The court considered internal consistency issues, examining the company's compensation policy for other employees, and whether the company compensates all employees, both shareholders and nonshareholders, at "top dollar." The court also considered whether the company paid any dividends.

The company had an employee handbook, which stated that salary would be determined by the company's president. The handbook did not include a written bonus policy.

Bonuses were paid based on the company's financial performance, employee job performance, and work ethic. The company paid dividends to J. Lipsmeyer in 2006 and 2007.

The shareholder employee compensation was compared to (1) distributions made to shareholders, (2) compensation paid to nonshareholder employees, and (3) compensation paid to the shareholder employee in previous years when the company had a limited number of officers.

Guideline Company Comparison

The Tax Court opined that comparison of compensation to the prevailing rates of compensation paid to employees in similar positions in comparable companies within the same industry is the most significant factor in determining whether compensation is reasonable.[31]

This comparison may include an analysis of (1) the actual industry-based compensation based on job titles and responsibilities or (2) financial ratios based on the compensation compared to sales, profit, assets, or other measures for the subject company and comparable companies.

All forms of compensation paid by guideline companies should be considered, including the following:

1. Salary and bonus
2. Stock and stock options
3. Use of company assets
4. Other benefits

Courts have recognized that employees performing a greater number of responsibilities should be paid a higher compensation. However, "stacking" should not be used. This means that compensation of a full-time CEO and the compensation of a full-time CFO should not be added together.

This is because it is challenging for one person to perform all the job responsibilities of two senior executives in a 40 to 60 hour work week. It may be more appropriate to determine market-based compensation for the higher paying position and increase it by a reasonable allowance.[32]

The Tax Court concluded that although the officers (1) were highly qualified for their positions, (2) had worked for the taxpayer corporation since its incorporation, and (3) were significantly involved with the taxpayer corporation's successful operations, their compensation was too high compared to the taxpayer corporation's gross and net income, as well as compared to compensation of similar positions at comparable companies.

Conclusion

The reasonableness of shareholder employee compensation in a closely held corporation is an important, and often controversial, issue for income tax purposes. Compensation that is considered reasonable by the corporate taxpayer is frequently considered unreasonable by the Service.

This is because a shareholder executive is often motivated to deviate from arm's-length compensation in order to minimize the income tax expense of the corporation.

The Service is concerned that excess owner/employee compensation (1) absorbs taxable corporate income and (2) represents a disguised nondeductible dividend to the shareholder. Excess owner/employee compensation may be disguised as a management fee or a consulting fee from related entities.

Additionally, a corporate taxpayer may attempt to deduct excess shareholder employee compensation in the form of bonuses and catch-up payments for previously rendered services.

The tax consequences associated with unreasonable compensation may be significant. The taxpayer bears the burden of proof that the reasonable compensation determination by the Service is incorrect.

Determining the reasonableness of shareholder employee compensation can be a challenging task. Over the years, the Service and the courts have developed numerous guidelines to enable corporate tax payers and their consultants (i.e., valuation analysts) to determine the reasonableness of shareholder employee compensation.

In whatever form the executive pay is reported, closely held companies should rely on valuation analysts to help them estimate a reasonable level of executive compensation in order to minimize the risk of being audited by the Service.

When performing a reasonable compensation analysis, it is important for the analyst to review federal statutes regarding reasonable compensation, and the factors and methods that the Service and courts have considered in their assessment of reasonable executive compensation in prior court cases.

Notes:

1. F-Star Property Management, Inc. v. Commissioner, T.C. Memo. 2013-6 (January 10, 2013).
2. Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, 680 F.3d 867 (May 17, 2012).
3. Internal Revenue Code Section 162(a)(1).
4. Treasury Regulation 1.162-7.
5. Mayson Manufacturing Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949).
6. Pulsar Components International, Inc. v. Commissioner, T.C. Memo. 1996-129 (Mar. 14, 1996).
7. Trucks, Inc. v. U.S., 588 F. Supp. 638 (D.C. Neb. 1984).
8. Elliotts, Inc. v. Commissioner, T.C. Memo. 1984-516 (Sept. 27, 1984).
9. F-Star Property Management, Inc. v. Commissioner, T.C. Memo. 2013-6 at *4 (January 10, 2013).
10. Id. at *12.
11. Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, 680 F.3d 867, 869 (May 17, 2012).
12. Elliotts, Inc., T.C. Memo. 1984-516.
13. Exacto Spring Corporation v. Commissioner, 196 F.3d 833, 838 (7th Cir. 1999).
14. Mulcahy, Pauritsch, Salvador & Co., 680 F.3d at 871.
15. Multi-Pak Corporation v Commissioner, T.C. Memo. 2010-139 (June 22, 2010).
16. Mulcahy, Pauritsch, Salvador & Co., 680 F.3d at 874.
17. Aries Communications Inc. & Subs. v. Commissioner, T.C. Memo. 2013-97 (April 10, 2013).
18. Stephen Kirkland, "Normalizing Owner's Compensation in Business Valuations," *The Value Examiner* (September/October 2013).
19. Ibid.
20. Adam Minow, "A Shareholder-Employees' Guide to Determining Their Worth," *California CPA Magazine* (January/February 2012).
21. Aries Communications Inc. & Subs., T.C. Memo. 2013-97 at *12.
22. Id. at *13.
23. Id.
24. Id. at *14.
25. Id.
26. Id. at *15.
27. Id.
28. K&K Veterinary Supply, Inc. v. Commissioner, T.C. Memo 2013-84 (March 25, 2013).
29. Id. at *6.
30. Id. at *7.
31. Id.
32. Kirkland, "Normalizing Owner's Compensation in Business Valuations."

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