Reasonableness of Compensation Analysis Insights

Reasonableness of Close Corporation Shareholder/Executive Compensation Analysis for Income Tax Deduction Purposes

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Financial advisers routinely analyze the reasonableness of close corporation shareholder/executive compensation for various reasons, including taxation, financial accounting, regulatory compliance, financing, ownership transition, litigation, and corporate governance reasons. Over the years, most of the statutory authority, administrative rulings, and judicial precedent related to the reasonableness of compensation have related to federal income tax controversies. Therefore, financial advisers often rely on this taxation-related professional guidance—even when analyzing the reasonableness of shareholder/executive compensation for nontaxation reasons. Accordingly, this discussion focuses on the analytical methods and the quantitative/qualitative factors developed by the Internal Revenue Service and by the federal courts—with regard to the determination of the reasonableness of shareholder/executive compensation.

Introduction

There are numerous reasons why financial advisers are asked to analyze the reasonableness of closely held corporation shareholder/employee executive compensation. These numerous reasons may be grouped into the following categories: ownership transition, financing, bankruptcy, taxation, ESOP transaction, regulatory compliance, shareholder and related litigation, and corporate governance.

Some of the individual reasons why financial advisers are asked to analyze the reasonableness of shareholder/employee executive compensation are summarized below.

Reasons to Analyze Shareholder/Executive Compensation

Related to ownership transition, the new owner of a fractional ownership interest (whether a controlling or a noncontrolling interest) in a close corporation would perform a due diligence analysis to determine if any shareholder/employee was earning in excess of a reasonable amount of executive compensation. Obviously, if one shareholder/employee is earning excess compensation, then the available company profits would be reduced for all remaining shareholders.

This same ownership transition reasonableness of compensation due diligence issue could be a concern of:

1. a potential joint venturer (if the joint venture will absorb some of the excess compensation) or
2. parties involved in the acquisition or merger of a close corporation, professional practice, or other professional service firm.

Related to financing, a potential lender would be interested in assurance that the debtor corporation will earn adequate profit and cash flow from which to service the new debt. If one or more shareholder/executives are earning a salary or bonus that is greater than reasonable compensation, then the debtor corporation may not be able to meet its debt service payments as they come due.

There are a number of reasons why parties involved in a bankruptcy would be interested in the reasonableness of the close corporation debtor-in-possession shareholder/executive compensation:

- First, all creditors (and the court) may want assurance that the debtor-in-possession assets are not being dissipated during the bankruptcy protection period.
- Second, creditors may want assurance that the values of their security interests are not being diminished.
- Third, all parties may want assurance that excess compensation will not cause (or exacerbate) the debtor corporation insolvency.

- Fourth, all creditors and equity holders may be concerned that one class of equity holders (i.e., shareholder/executives) are receiving preferential treatment.
- And, fifth, all parties (including the court) are interested in whether the debtor can actually achieve its proposed plan of reorganization. Unreasonably high levels of shareholder executive compensation may affect the financial feasibility of the proposed reorganization plan.

The Internal Revenue Service (the "Service") is particularly interested in the reasonableness of shareholder/executive compensation in close corporations. The Service is concerned with unreasonably high compensation in the case of C corporations. In such cases, excess compensation absorbs taxable income and (according to the Service) represents a disguised dividend.

The Service is also concerned with unreasonably low compensation in the case of S corporations. In such cases, both the S corporation and the shareholders avoid paying payroll-related taxes when the shareholders take noncompensation distributions.

In addition, the Service is also concerned about how the reasonableness shareholder/executive compensation affects close corporation stock valuations in matters related to gift tax, estate tax, and charitable contribution deductions.

In ESOP purchases of employer corporation stock, the ESOP trustee (on behalf of the plan participants) is concerned that the remaining shareholder/executives may be taking a disproportionate percentage of company profits in the form of excess compensation. In such instances, there may not be sufficient remaining profit or cash flow to provide for a fair return on the ESOP's investment in the employer corporation stock.

In addition, the leveraged ESOP lending institution may be concerned that the ESOP can pay back the employer stock acquisition loan. If shareholder/executives are earning excessive compensation, then there may not be sufficient remaining profit or cash flow for the employer corporation to make the level of ESOP contributions necessary to service the ESOP debt.

Even if they do not have corporate "shareholders," directors of not-for-profit institutions (and similar regulated entities) are concerned with excess professional/executive compensation issues. This concern is raised because such institutions want to avoid allegations of the private inurement (i.e., to overpaid administrators, physicians, researchers, etc.) of not-for-profit assets that should be dedicated to the public benefit.

Allegations of unreasonable shareholder/executive compensation are common in certain types of litigation. These types of litigation include: dissenting shareholder appraisal rights matters, minority shareholder oppression claims, breach of contract or joint venture disputes, breach of buy/sell agreement allegations, and family law disputes (when a close corporation or a professional practice is an asset of the marital estate).

And, as a matter of corporate governance, corporation boards of directors are concerned about the reasonableness of all executive compensation. This concern is valid whether the corporation is closely held or publicly traded. And, this concern is valid whether the executives are shareholders or not. This is because the corporation directors are generally concerned about the financial reporting, income taxation, shareholder relations, public relations, regulatory compliance, and shareholder abuse allegation aspects of unreasonable executive compensation.

"In such cases, excess compensation absorbs taxable income and (according to the Service) represents a disguised dividend."

Discussion Focus

As indicated above, there are numerous reasons to analyze the reasonableness of shareholder/executive compensation. However, most of the statutory authority, administrative guidance, and judicial precedent are in the area of federal income tax.

Therefore, when analyzing the reasonableness of shareholder/executive compensation for any purpose, financial advisers often rely on the analytical methods and the qualitative/quantitative factors developed in the federal income tax area.

Accordingly, this discussion will focus on the professional guidance provided by federal income taxation authority to determine the reasonableness of shareholder/executive compensation. It is noteworthy that financial advisers agree that this professional guidance is also generally applicable to reasonableness of executive compensation analyses performed for nontaxation purposes. Also, this discussion will describe some of the reasons why financial advisers are particularly well-qualified to analyze the reasonableness of shareholder/executive compensation.

Income Tax Deductions for Shareholder/Employee Compensation

For federal income tax purposes, an employer corporation may claim a tax deduction for a reasonable compensation amount for services actually rendered by its executives. This tax deduction is allowed regardless of whether the executive is also a shareholder of the corporation.

However, in the case of a shareholder/employee, the Service may apply particular scrutiny to the issue of whether the compensation amount is reasonable. The Service may apply particular scrutiny when:

1. the taxpayer corporation is a closely held corporation and
2. the subject executive owns a significant percentage of the closely held corporation stock.

Type of Shareholder/Employee Compensation

For example, a reasonable amount of employee compensation can be paid (and deducted) by the taxpayer corporation in the form of:

1. a fixed salary,
2. a percentage of the corporation gross income or net income,
3. commissions on sales
4. regular or occasional bonuses, including noncash compensation,
5. a contribution to a pension or profit-sharing plan, or
6. a combination of any of these forms of compensation.

". . . in the case of a shareholder/employee, the Service may apply particular scrutiny to the issue of whether the compensation amount is reasonable."

The form of the employee compensation does not affect its tax deductibility to the employer corporation.

However, in order to be tax deductible to the employer corporation, the employee compensation must meet four requirements. These four requirements for an employee compensation tax deduction are described in Regulation 1.162-7:

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.

"A determination of what is a reasonable amount of executive compensation is made based on the specific facts of each individual case."

A publicly held corporation is subject to a special limitation on the tax deduction related to executive compensation. This is true regardless of whether the executive is also a stockholder in the public corporation.

However, this discussion will focus on the issues related to the reasonableness of shareholder/executive compensation in closely held corporations. Therefore, the limitations related to the tax deductibility of public corporation executive compensation are beyond the scope of this discussion.

Requirements for Income Tax Deductibility

In order to be deductible by the taxpayer corporation, executive compensation for personal services must be (1) reasonable in amount and (2) based on services actually performed.

Like other business expenses, salaries, wages, and other executive compensation must be directly connected with a trade or business in order to qualify for a tax deduction.

A determination of what is a reasonable amount of executive compensation is made based on the specific facts of each individual case. According to Regulations 1.162-7 and 1.162-8, this determination is made based on the subject taxpayer facts that exist at the time the executive compensation is paid—and not based on the taxpayer facts that exist at the time the executive compensation is challenged by the Service.

If challenged by the Service, the taxpayer corporation bears the burden of proof that the amount of the shareholder/executive compensation is reasonable. This taxpayer corporation burden was established in *Long Island Drug Co., Inc. v. Commissioner*, 111 F.2d 593 (2d Cir. 1940). If some amount of the executive compensation is determined to be excessive, then only that portion of the executive compensation that is determined to be reasonable will be deductible.

The nominal amount of the shareholder/executive compensation paid is not determinative of its reasonableness. For example, different courts, based on different sets of facts, have determined that a million dollar executive salary amount is both (1) reasonable compensation and (2) unreasonable compensation.

For example, a $1 million executive salary was determined to be reasonable by the Tax Court in *Home Interiors & Gifts, Inc. v. Commissioner*, 73 TC 1142 (1980). However, a $1 million executive salary was determined to be unreasonable by the Tax Court in *H.L. Foos*, 41 TCM 863, TC Memo. 1981-61. The respective courts made these two determinations based on the individual facts and circumstances in each instant case.

The *Mayson Manufacturing Company* Factors

If the income tax deduction is challenged by the Service, the factors that are typically considered in determining the reasonableness of executive compensation have been established over the years by the courts. A commonly cited list of ten reasonableness of executive compensation factors is the list presented in *Mayson Manufacturing Co.*, 178 F.2d 115 (6th Cir. 1949).

These ten *Mayson Manufacturing Co*. factors include the following:

1. the employee's qualifications;
2. the nature, extent, and scope of the employee's work;
3. the time devoted by the employee to the enterprise, and the employee's particular ability or special talent;
4. the size and complexity of the subject business;
5. comparison of salaries paid with the gross income and with the net income of the subject business;
6. comparison of salaries with any distributions to the corporation stockholders;
7. prevailing rates of compensation for comparable positions in comparable businesses;
8. the salary policy of the employer corporation with regard to all of its employees;
9. the amount of compensation paid to the particular employee in previous years;
10. the existence of the employee's agreement not to compete.

> *"A commonly cited list of ten reasonableness of executive compensation factors is the list presented in* Mayson Manufacturing Co.*"*

The Independent Investor Test

In addition to consideration of the so-called *Mayson Manufacturing Co*. factors, several recent judicial decisions have considered what is commonly called the "independent investor test." As articulated by the Tax Court in *Elliotts, Inc*., 48 TCM 1245, TC Memo. 1984-516, the independent investor test considers whether an outside investor in the taxpayer corporation would have approved the subject executive compensation.

In the *Exacto Spring Corp. v. Commissioner* decision (196 F.3d 833 (7th Cir. 1999), *rev'g* TC Memo 1998-220), the U.S. Court of Appeals for the Seventh Circuit rejected the Tax Court's use of a seven-factor test. The Tax Court had used this seven factor test to determine whether the executive compensation paid to a taxpayer corporation CEO was reasonable. In making its decision, the Tax Court had used such factors as:

1. the type and extent of the services actually rendered and
2. the qualifications of the subject executive.

However, the Court of Appeals concluded that using such factors was improper. In its decision, the Appeals Court concluded that such factors could lead to an arbitrary decision.

In the *Exacto Spring Corp*. decision, the Appeals Court applied an independent investor (or indirect-market) test. This independent investor test concludes that the subject executive compensation is reasonable if that corporation's actual or hypothetical independent investors earn a market-derived required rate of return.

In the *Exacto Spring Corp*. decision, the Appeals Court concluded that the independent investor rate-of-return test was passed. Therefore, the Appeals Court concluded that the *Exacto Spring Corp*. shareholder/executive compensation was reasonable.

Shareholder/Executive Control Over the Taxpayer Corporation

Typically, the Service will not raise the issue of reasonableness of shareholder/executive compensation unless the employee executive maintains some element of control over the employer corporation. Therefore, the Service most commonly scrutinizes the reasonableness of executive compensation in the case of a closely held corporation.

In one judicial decision, the compensation paid throughout the tax year by a closely held corporation to the son of the president/controlling shareholder was concluded to be unreasonable. A District Court concluded the extent that the son's salary was unrelated to the value of his services as a part-time summer employee. The District Court reached this conclusion in the decision *Caledonian Record Publishing Co., Inc. v. United States*, 579 F.Supp 449 (D.Vt. 1983).

However, in *Yeomans Distributing Co*., 607 F.Supp 42 (C.D.Ill. 1985), another District Court concluded that the payments made by a closely held corporation to its retired founder were reasonable in amount. The payments made to the retired shareholder/employee represented catch-up remuneration for services previously rendered to the closely held taxpayer corporation. The District Court determined that those previous services had been inadequately compensated for at the time of their performance.

Reasonable Compensation for the Efforts of the Shareholder/Executive

In most reasonableness of executive compensation disputes, the Service argues that the subject compensation is unreasonable because it is excessive in light of the level of compensation paid to comparable employees in similar occupations. In response, the taxpayer corporation typically contends that, because of the employee's unique contributions to the taxpayer business, the subject executive compensation is reasonable.

Executive Compensation Surveys

In such disputes, the courts have ruled that published compensation surveys are not dispositive of the reasonableness of executive compensation analysis. For example, see *H.L. Foos*, 41 TCM 863, TC Memo. 1981-61. Nonetheless, the courts have also held that such published compensation surveys are a key factor to be considered in the reasonableness of shareholder/executive compensation.

Of course, the compensation survey comparison should be made with similarly situated employees in comparable companies. The issue of what qualifies as a comparable employee is not an unambiguous issue. Likewise, the issue of what qualifies as a comparable company is also not an unambiguous issue.

For example, in *W.C. Neils*, 43 TCM 982, TC Memo. 1982-173, the Tax Court concluded that the compensation paid to employees of a direct competitor of the taxpayer corporation is irrelevant when the competitor:

1. carries product lines in addition to the directly competing product lines and
2. provides different kinds of customer services than the subject taxpayer corporation.

". . . the courts have also held that such published compensation surveys are a key factor to be considered in the reasonableness of shareholder/executive compensation."

According to the Tax Court in the *W.C. Neils* decision, these differences were sufficient to invalidate the use of the competitor company employees as "comparable employees in comparable companies" for purposes of concluding the reasonableness of the taxpayer corporation executive compensation.

Services Actually Performed by the Shareholder/Executive

In order to be tax deductible, employee compensation must be paid or incurred for services actually performed for the taxpayer corporation. Likewise, the services must be of a type that would reasonably be expected to benefit the taxpayer business.

The employee services need not be performed during the current tax year. However, the employee compensation must actually be paid or incurred during the current tax year. That rule was concluded by the Tax Court in *Estate of Senior v. Commissioner*, 12 TCM 90 (1953).

With regard to the timing of the tax deduction, courts have concluded that compensation paid to employees who are absent while serving in the Armed Forces, or payments to the dependents of absent employees serving in the Armed Forces, are deductible. Of course, this is true only if the compensation is reasonable in amount. The same timing of tax deduction rule applies to compensation paid to employees who are on leave for military duty in National Guard or Reserve camps.

A further requirement for the tax deduction of compensation is that the payment must be made with an "intent to compensate" for the services rendered. For example, a closely held corporation that purchased insurance on the life of its retired shareholder/president was not permitted to deduct as compensation the insurance premiums it paid. The Court disallowed the compensation deduction despite the fact that, after his retirement, the president rendered valuable services to the closely held corporation.

This decision was reached in *Whitcomb v. Commissioner*, 733 F.2d 191 (1st Cir. 1984), *aff'g* 81 T.C. No. 30, 81 T.C. 505 (1983). This decision was reached because the Appeals Court (and, originally, the Tax Court) concluded that the payment of the premiums was not made with an "intent to compensate."

Timing of the Income Tax Deduction

In determining whether the compensation expense for services rendered are current by an accrual-basis taxpayer employer, all of the events that establish liability for an amount are treated as not occurring before "economic performance" occurs with respect to the subject expense. This "economic performance" test is described in Internal Revenue Code Section 461(b).

In the case of an accrued compensation liability that requires a payment for employee services rendered to the taxpayer corporation, "economic performance" is deemed to occur as the employee services are actually provided to the taxpayer corporation. This conclusion was reached by the Tax Court in *Vander Poel, Francis & Co., Inc. v. C.I.R.,* 8 TC 407 (1947).

For employer corporations on the accrual method of accounting, the tax deduction is allowed when the obligation to pay the executive compensation is established. For example, in many closely held corporations, executive compensation bonuses are not decided until the year after the year in which the employe services were rendered.

In some instances, such executive/shareholder bonuses may be based on employee services rendered over several years. In such instances, the accrual basis taxpayer corporation may claim the tax deduction in the year in which the executive bonus liability is established.

For both accrual basis and cash basis employer taxpayers, a deduction is allowed in the year in which the additional compensation is authorized. This rule is well-established and was concluded years ago by the Supreme Court in *Lucas v. Ox Fibre Brush Co*., 281 U.S. 115, 50 S.Ct. 273 (1930).

Special Considerations for Closely Held Corporations

With regard to the issue of the tax deduction for executive compensation paid, closely held corporations are generally subject to close scrutiny by the Service. This is because the subject shareholder/executives may also own a majority of the stock of the closely held taxpayer corporation.

In the case of closely held corporations, coordinated audits of corporate and individual returns are fairly common. In these cases, the Service often examines whether the amount that would be executive compensation paid (and therefore deductible) is comparable to the amount that could be paid in the case of similar corporations that are not closely held.

"The fact that a closely held corporation has a low/no dividend history does not, in itself, exclude a tax deduction for reasonable compensation paid to a shareholder/executive."

The fact that a closely held corporation has a low/no dividend history does not, in itself, exclude a tax deduction for reasonable compensation paid to a shareholder/executive. That principle is documented in Revenue Ruling 79-8.

However, the Service may consider the absence of a dividend history, in general, to be indicative of an intent to pay out close corporation profits as shareholder/executive compensation. An example of that situation may be found in *Charles McCandless Tile Services*, 422 F.2d 1336 (Ct. Cl. 1970). Nonetheless, as concluded by the Ninth Circuit in the *Elliotts, Inc.*, decision referenced above, payments made by a profitable close corporation as shareholder/executive compensation can constitute tax deductible employee compensation if the payments are reasonable in amount.

In the typical close corporation audit, the Service usually assigns little weight to:

1. employment contracts executed after a shareholder/executive of a close corporation has acquired control or
2. compensation amounts voted on by a board of directors controlled by the shareholder/executive.

As concluded by the Tax Court (and affirmed by the Third Circuit) in *Glenshaw Glass Co., Inc. v. C.I.R.*, 5 TCM 864, *aff'd per curiam* 175 F.2d 776 (3d Cir. 1947), such administrative formalities are not considered determinative of whether the shareholder/executive compensation is or is not reasonable.

Close Corporation Audit Issues

In addition, the Service often considers bonuses that are fixed toward the end of a year as being an adjustment so that the deductible compensation will absorb as much close corporation income as possible. Also, the Service may disallow increased salaries and deferred compensation paid to a shareholder/executive by a closely held corporation where the compensation increase occurs after a sudden increase in the taxpayer corporation profits.

And, the District Court reached the same conclusion in *M&K Farms, Inc*. v. U.S., 556 F.Supp 50 (D. Mont. 1982).

During the close corporation audit, the Service looks for a provision in an employment contract or in the by-laws of the close corporation that requires the repayment of any salary or bonus later determined to be unreasonable (i.e., nondeductible). The Service considers such provisions to be an indication that the corporate taxpayer itself had some doubt as to the reasonableness of the shareholder/executive compensation.

In fact, several Tax Court decisions have reached the same conclusion, including *Castle Ford, Inc. v. Commissioner*, 37 TCM 692, TC Memo. 1978-157.

Shareholder/Executive Bonus Payments

Shareholder/executive bonuses are tax deductible if they are paid for services actually rendered. Of course, the bonus amount will be added to all other shareholder/executive salary, and the total amount should not exceed a reasonable amount of compensation. This total compensation reasonableness test is documented in Regulation 1.162-9.

The shareholder/executive bonuses should be intended as additional pay for actual services. In other words, the bonuses should not be gifts and must be paid for services actually rendered by the shareholder/executive. The bonuses may be paid in cash, property, or in any combination thereof.

However, according to Revenue Ruling 84-68, a parent corporation was not allowed to deduct cash bonuses that it paid to the employees of its wholly-owned subsidiary. This is because one taxpayer corporation cannot deduct the compensation expense of another taxpayer corporation.

Particularly in the case of a close corporation, the Service will scrutinize year-end shareholder/executive bonuses to look for two attributes:

1. if the bonus absorbs virtually all of the otherwise taxable income of the taxpayer close corporation, or
2. if the bonus is distributed to the shareholder/executives in proportion to their equity ownership in the taxpayer close corporation.

In such instances, the tax deduction for the year-end bonuses may be disallowed, at least in part. For one example of a judicial endorsement of these bonus deduction disallowance factors, see *Doernbecher Mfg. Co. v. Commissioner*, 95 F.2d 296 (9th Cir. 1938).

Even the payment of a bonus based on a percentage of taxpayer corporation pretax profits to a nonshareholder/executive as well as to a shareholder/executive does not ensure that the bonus will be treated as compensation. For example, see *Knodel-Tygrett Company v. U.S.*, 627 F.2d 1091 (Table), 1980 WL 99785 (unpublished decision) (6th Cir. 1980).

In contrast, a taxpayer corporation was allowed to deduct the entire amount of the bonuses paid to its president and 50 percent shareholder. In *Railroad Dynamics, Inc*., 47 TCM 957, TC Memo. 1984-40, the Tax Court concluded that:

1. the shareholder/executive bonus amount was reasonable and
2. the bonus payment was entirely for services actually rendered.

In addition, in *Railroad Dynamics, Inc.*, the Tax Court found that the bonus was not a disguised dividend. The Tax Court reached this decision because there were independent corporate reasons for the shareholder/executive bonus payments.

Formula-Based Executive Compensation

According to Regulations 1.162-7 and 1.1032-1, a taxpayer corporation may deduct shareholder/executive compensation payment that are based on a percentage formula. 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.

However, the formula-based shareholder/executive compensation payments should be:

1. reasonable in amount,
2. based on services actually performed, and
3. paid or incurred in the year in which the deduction is claimed.

As a general rule, a tax deduction is allowed for compensation paid on a percentage basis pursuant to a free bargain entered into by the employer corporation and the shareholder/executive before the services are rendered. The tax deduction is allowed if the percentage compensation is not influenced by any consideration on the part of the taxpayer corporation—other than that of securing on fair and advantageous terms the services of the shareholder/executive.

The tax deduction should be allowed even if the percentage compensation agreement results in the payment of an amount greater than the amount that would ordinarily be paid.

". . . the Service will scrutinize year-end shareholder/executive bonuses to look for two attributes. . . ."

The "Free Bargain Rule"

This so-called "free bargain rule" has been the subject of much litigation in cases involving percentage compensation amounts paid to shareholder/executives of closely held corporations. Based on the conclusions of these various judicial decisions, the following "free bargain rule" guidelines have emerged:

1. A tax deduction is allowed for compensation payments made pursuant to an agreement where (a) the shareholder/employees are not controlling shareholders, (b) the salaries do not bear any relationship to the percentage of the employee, and (c) the total amount of compensation is reasonable in amount.

   This guidance comes from the Tax Court decision in *California Vegetable Concentrates, Inc. v. C.I.R.*, 10 TC 1158 (1948).

2. Employee agreements providing for percentage compensation are not controlling on the tax deductibility of the payments when the employee or employees are either (a) the sole shareholder of the close corporation or (b) the controlling shareholder/shareholders of the close corporation.

   This guidance comes from a number of judicial decisions; including *Kennedy* v. C.I.R., 671 F.2d 167 (6th Cir. 1982), *rev'g* 72 T.C. 793.

3. Percentage compensation arrangements were upheld during the period when the shareholder/employee held a noncontrolling interest in the closely held taxpayer corporation. However, such percentage compensation agreements lost their arm's-length status once the shareholder/employee gained control of the closely held taxpayer corporation.

   This guidance also comes from a number of judicial decisions, including *R.J. Clymer, Jr.*, 47 TCM 1576, TC Memo 1984-203.
4. A reasonable percentage bonus paid to a nonshareholder/employee may not be reasonable if it is paid to a large shareholder of the taxpayer corporation. This is because the percentage bonus incentive would not be needed to secure the shareholder's best efforts.

   This guidance was described in *Giles Industries, Inc.*, 496 F.2d 556 (Ct. Cl. 1974).
5. The fact that the shareholder/executive compensation is paid under a long-standing percentage of profits agreement is not controlling as to the question of reasonableness of executive compensation. However, a long-standing percentage of profits agreement does not violate the "free bargain rule" when the taxpayer close corporation has an independent board of directors.

   This guidance is described in *Home Interiors and Gifts, Inc.*, 73 TC 1142 (1980).

Compensation in a Form Other than Cash

A tax deduction is allowed for the payment of shareholder/executive compensation in a form other than cash. The tax deduction is allowed in an amount equal to the fair market value of the property transferred. The tax deduction is allowed to the extent that the total amount of the shareholder/executive compensation is reasonable.

The general rule for tax deduction of shareholder/executive wages and salaries also applies to compensation paid in a form other than in cash. That is, the aggregate amount of the shareholder/executive compensation must be reasonable. And, the shareholder/executive compensation cannot be a nondeductible dividend disguised as tax deductible compensation.

This principle was established long ago by *Genaiden Realty Corp. v. C.I.R.*, 20 B.T.A. 1204, 1930 WL 466 (B.T.A. 1930).

"The tax deduction is allowed in an amount equal to the fair market value of the property transferred."

Special Considerations for S Corporations

The Service also pays particular attention to the compensation paid to shareholder/executives of S corporations. By definition, S corporations are closely held. That is, an S corporation has a maximum of 100 shareholders.

The Service's concern with regard to S corporations is that the shareholder/executives pay themselves less than a reasonable amount of employee compensation. The Service examines S corporations to determine if shareholder/executives are taking S corporation distributions that should be recorded as employee compensation. The motivation for S corporation executive/shareholders to recognize less than reasonable compensation is that employee compensation is subject to employment taxes (e.g., FICA, FUTA, SUTA, etc.). In contrast, S corporation shareholder distributions are not subject to employment-related taxes.

As with a C corporation, the basic rule is that the S corporation shareholder/executive compensation must be (1) reasonable in amount and (2) purely for services rendered. This basic rule is provided in Regulation 1.162-7(a). Moreover, under Regulation 31.3121(d)-1(b), S corporation officers are considered to be employees of the taxpayer corporation when they provide "substantial services" to that corporation. In addition, according to Revenue Ruling 59-221, S corporation shareholder income distributions are exempt from self-employment tax.

The Trucks, Inc. Factors

S corporations that do not follow these rules are subject to the Service's recharacterization of any payments made from the corporation to the shareholder/executive, such as dividends, draws, and other distributions. The result of such a recharacterization is the imposition of employment-related taxes under Sections 3111, 3301, and 3401. In addition, the S corporation faces the potential of: (1) Section 6641(a)(1) failure to file penalties, (2) Section 6656(b)(1) failure to deposit penalties, and (3) Section 6662(c) negligence penalties.

As it is with a C corporation taxpayer, the burden of proof is on the S corporation taxpayer to show that the S corporation income distributions are properly characterized and reasonable.

As with a C corporation, the Service determines the reasonableness of S corporation shareholder/executive compensation according to the facts and circumstances of each individual case. According to the Service, the nature of an S corporation as a flowthrough entity results in even less of an arm's-length bargaining situation than in the case of a closely held C corporation.

Exhibit 1 presents the factors that the courts have typically considered with regard to an analysis of the reasonableness of S corporation shareholder/executive compensation. This list of factors was first articulated by the District Court in *Trucks, Inc. v. U.S.*, 588 F.Supp. 638 (D.C.Neb. 1984).

Using these *Trucks, Inc.*, factors, the courts have generally grouped the S corporation reasonableness of compensation analyses into three broad categories:

1. the employee's performance,
2. objective salary comparisons, and
3. the subject company conditions.

An Illustrative S Corporation Case Decision

In *Joseph Radtke, S.C.*, 895 F.2d 1196 (7th Cir. 1990), the distribution payments from an S corporation to the shareholder/employee (i.e., a Milwaukee attorney), were initially characterized as S corporation dividends. Joseph Radtke was the sole director, sole shareholder, and only full-time employee of the S corporation taxpayer. Radtke's annual base salary was zero. However, he received more than $18,000 a year in dividends. The Seventh Circuit upheld the District Court's decision that the $18,000 was actually remuneration for employee services. In other words, the $18,000 was not dividends, as has been filed by the taxpayer corporation.

Revenue Rulings

In Revenue Ruling 82-83, two S corporation shareholder/employees were treated as independent contractors, rather than as employees. The S corporation paid them a draw and not a salary. The Revenue Ruling concluded that the "duties being performed customarily fall within the scope of duties of corporate officers," such as management and operational decisions. Therefore, this revenue ruling concluded that the two S corporation shareholders were employees.

Revenue Ruling 73-361 also distinguished between a shareholder and an employee. Revenue Ruling 73-361 concluded that a shareholder/executive who performed substantial services as an S corporation officer received a salary, and not an owner's draw of S corporation income.

Finally, Revenue Ruling 59-221 determined that the taxpayer S corporation's gross income was not earnings from self-employment (under Section 1402) based on original intent. Revenue Ruling 59-221 reached this conclusion because the individual shareholder/employee was not in "the conduct of a trade or business." Revenue Ruling 59-221 concluded that it was the S corporation that conducted business—with the "help" of its shareholder/employee.

Executive Compensation Analysts

Many users of executive compensation analyses (e.g., corporation directors, auditors, lawyers, regulators, etc.) rely on compensation consulting firms to perform such analyses. Compensation consulting firms have expertise with regard to the design of corporate employee evaluation and compensation systems.

Exhibit 1
The *Trucks, Inc.,* Factors Related to the Reasonableness of S Corporation Shareholder/Executive Compensation

- Employee qualifications and training
- Nature, extent, and scope of employee duties
- Responsibilities and number of hours involved
- Size and complexity of the subject business
- Results of the employee's efforts
- Prevailing rates for comparable employees in comparable businesses
- Ratio of compensation to company growth and net income (measured before salaries and tax)
- Absence of usual fringe benefits (pension or profit-sharing plan, stock options, etc.), which are available to executives of other companies of comparable size
- Employee's responsibility for the company's inception and/or success
- Time of year the compensation was determined and by whom
- Correlation between the shareholder/executive compensation and his/her ownership interest
- The corporation's dividend history
- Prevailing economic conditions
- Examination of the financial condition of the subject company after paying the compensation
- Whether an independent investor would be willing to compensate the shareholder/executive at the amount that he/she was compensated

Compensation Consultants

Compensation consultants also have expertise with regard to organization compensation issues, such as what one job is worth compared to another job within a large organization. And, compensation consultants have expertise with regard to determining average compensation levels and narrow ranges of compensation levels both for (1) individual job descriptions and (2) categories of job descriptions.

However, compensation consulting firms may not be the best suited professionals to determine the reasonableness of an individual shareholder/executive's compensation. Compensation consultants generally evaluate job descriptions—not individuals.

And, most reasonableness of compensation disputes do not arise around the average amount (or even interquartile range) of executive compensation. Rather, such disputes arise when an individual executive appears to be paid an extremely high (or an extremely low) amount of compensation.

The issue in reasonableness of executive compensation analyses is not: What is the typical range of compensation for the typical executive in the typical executive position (e.g., the CEO)? Rather, the issue in reasonableness of executive compensation analyses is: At what point is the compensation paid to an individual executive unreasonable—given that individual executive's unique skills, job performance, and contribution to the specific corporation?

That question can only be answered by reference to the specific financial/operational performance of the individual executive—compared to the actual financial/operational performance of comparable companies, industry peer group, subject company historical/planned performance, or other market-derived benchmarks.

Financial Advisers

Financial advisers have expertise with regard to:

1. selecting/analyzing comparable companies;
2. assessing industry trends and benchmarks;
3. quantifying performance metrics such as growth rates, profit margins, and rates of return;
4. performing ratio, trendline, and common size analyses of actual performance versus benchmark performance; and
5. assessing an individual's financial/operational performance.

While compensation consultants are skilled at assessing what the hypothetical typical executive is worth (in terms of compensation), financial advisers are skilled at assessing what a specific individual is worth (in terms of contribution to the subject company).

In other words, financial advisers are more experienced at assessing the value of the actual performance of extremely successful (or extremely unsuccessful) executives. And, reasonableness of executive compensation disputes more typically involve correlating superior levels of compensation to superior levels of performance than they involve correlating average levels of compensation to average levels of performance.

Summary and Conclusion

Reasonableness of shareholder/executive compensation analyses are performed for various financial accounting, taxation, transaction, financing regulatory, litigation, and corporate governance reasons. Of all of these reasons, most of the reasonableness of executive compensation statutory authority, administrative guidance, and judicial precedent relate to federal income taxation disputes.

Therefore, financial advisers often rely on this income taxation-related professional guidance when assessing the reasonableness of shareholder/executive compensation—even for nontaxation purposes.

This discussion focused on the federal income-taxation-derived approaches, methods, and procedures for determining the reasonableness of shareholder/executive compensation. These methods and factors relate (albeit in different ways) to both C corporations and S corporations. And, this discussion reviewed the quantitative and qualitative factors that the Service and the courts have concluded are appropriate to assessing the reasonableness of such shareholder/executive compensation.

Financial advisers typically perform such methods and consider such factors when they determine the reasonableness of shareholder/executive compensation for various purposes.

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