Best Practices Discussion

Shareholder/Executive Reasonableness of Compensation—Practical Guidance

Casey D. Karlsen and Lisa H. Tran

C corporations and S corporations should pay shareholder/executive compensation based on the fair market value of the executive services rendered—or risk being audited and possibly penalized by the Internal Revenue Service. Forensic analysts can help companies determine reasonable shareholder/executive compensation using free or fee-based compensation data, with consideration of statutory authority and judicial precedent. This discussion (1) summarizes the federal income tax statutes and judicial precedents related to shareholder/executive compensation, (2) provides a list of frequently relied upon executive compensation data sources, and (3) reviews important issues presented in recent judicial decisions regarding shareholder executive compensation.

Introduction

In general, overcompensation of shareholder/executives is a common federal income tax issue, particularly for closely held C corporations. Executive compensation is a deductible business expense, and it reduces the amount of income taxes paid on a company's taxable income.

Dividends paid to shareholders are not deductible for federal income taxes purposes. This fact encourages some closely held companies to overcompensate their shareholder/executives.

On the other hand, S corporations, in particular, may undercompensate shareholder/executives. This is because compensation is subject to federal and state payroll taxes and dividends and distributions are not. Due to the significant increase in the number of S corporations today, the Internal Revenue Service (the "Service") is investing more effort into reviewing the reported shareholder/executive compensation of closely held S corporations.

In recent years, shareholder/executive compensation was heavily scrutinized by the Service and by the Tax Court, and many disputes have resulted in litigation. Whether shareholder/executive compensation is overpaid or underpaid, reasonable compensation should be determined based on the fair market value of the services rendered. Because determining reasonable shareholder/executive compensation can be a challenging task, the retention of an independent forensic analyst ("analyst") may be necessary.

This discussion (1) summarizes the federal tax statutes and historical judicial precedents related to shareholder/executive compensation that are commonly relied upon by analysts and the Service to estimate reasonable compensation, (2) provides a list of frequently relied upon sources of executive compensation data, and (3) reviews important issues presented in recent judicial decisions regarding shareholder/executive reasonable compensation.

Legislative and Judicial Guidance

To determine the reasonableness of shareholder/executive compensation, analysts should consider both statutory authority and judicial guidance. Internal Revenue Code Section 162(a) provides that executive compensation is deductible as a business expense if it is:

1. reasonable in amount and
2. based on the services actually rendered.

For shareholder/executive compensation to qualify as reasonable 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 tax payer corporation.

Judicial precedent also provides guidance related to reasonableness of executive compensation. Factors to consider in determining the reasonableness of shareholder/executive compensation were first presented by the Court of Appeals for the Sixth Circuit 68 years ago in the *Mayson Manufacturing Company v. Commissioner*[1] decision. 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*[2] 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.*[3] decision, some of the factors considered regarding the shareholder employee in determining the reasonableness of shareholder/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*[4] decision.

In the independent investor test, the Tax Court considered whether an independent investor would pay the shareholder/executive the same compensation he or she was receiving from the company. The Tax 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.

Executive Compensation Sources

In addition to reviewing federal statutes and judicial guidance, the expert witness can estimate reasonable compensation by analyzing compensation data for job positions at comparable companies.

This is important since the Tax Court has indicated that it favors the use of market-based data to determine reasonable compensation, whereby the shareholder/executive compensation in question is compared to the market-based compensation of an executive performing similar job responsibilities at a similar company.

The analyst can find a variety of compensation information available to estimate market-based executive compensation. Determining which sources to use will depend on whether a particular source provides compensation for a specific industry or a specific job title and the price of the source (some compensation databases are free and some may cost thousands of dollars). Some sources provide base

salaries while some sources provide total compensation, including salaries and benefits.

A sample list of commonly used compensation sources are discussed below:[5]

1. **Economic Research Institute** ("ERI"). ERI offers salary and other data for more than 7,000 positions in more than 8,000 locations for a fee. ERI offers information such as base salary, total compensation, and annual incentives for each job position. The valuation analyst can search the ERI database by city, state, job title, Standard Industrial Classification ("SIC") code or North American Industry Classification System ("NAICS") classifications, date (historical information available), and company revenue.

   The analyst can obtain compensation data in the 10th percentile, 25th percentile, 50th percentile, 75th percentile, and 90th percentile.

2. **Willis Towers Watson Data Services**. Willis Towers Watson, a compensation and benefits consulting company, publishes and offers (for a fee) several different compensation surveys.

   The surveys provide information such as salaries, short-term incentives, sales incentives, overtime policies, deferred compensation for executives, and turnover rates.

3. **Bureau of Labor Statistics** ("BLS"). Providing a free online source of salary information, BLS is a division of the U.S. Department of Labor. BLS offers salary information by occupation, region, state, and cities.

   BLS also publishes reports on benefits and employer compensation costs. Some data on the BLS website are available historically as well.

4. **Salary.com**. Salary.com is a website that contains several databases and provides salary information regarding 4,200 jobs. The data have been gathered from surveys of human resources personnel.

   The information is updated monthly. Some of the databases are subscription based. One database is free but does not include much detail and is only available on a current basis.

These executive compensation data provide the analyst with a starting point for assessing reasonable compensation that should be supported by company-specific factors. For example, the analyst may consider the number of hours worked, job title, and related responsibilities of a shareholder/executive. It may be reasonable to pay an executive working 80 hours a week and performing several significant job functions compensation in the 90th percentile.

Additionally, the analyst may consider whether a company is profitable or unprofitable. If the subject company is unprofitable, a shareholder/executive compensated at the high end of the salary range may be overcompensated.

Recent Judicial Decisions

The following discussion summarizes recent judicial decisions, which emphasize the importance of (1) retaining an independent, qualified analyst to estimate shareholder/executive compensation and (2) considering the independent investor test and other factors introduced in prior judicial decisions regarding the estimation of reasonable shareholder/executive compensation.

H.W. Johnson, Inc. v. Commissioner

In *H.W. Johnson, Inc. v. Commissioner*,[6] the Tax Court considered five relevant factors and concluded that the compensation paid by a concrete contracting business ("H.W. Johnson") to two shareholder executives in 2003 and 2004 was reasonable and, therefore, deductible under Internal Revenue Code Section 162(a).

H.W. Johnson was incorporated in 1974 by H.W. and Margaret Johnson. Their sons, Bruce and Donald Johnson, began working for H.W. Johnson as teenagers in the 1970s and began working full time upon completion of their education. Beginning in 1993, Bruce and Donald assumed responsibility of the daily operations of H.W. Johnson, including contract bidding and negotiation, project scheduling and management, personnel management, and customer relationships.

In 1996, H.W. retired, and Bruce and Donald each acquired a 24.5 percent ownership interest in H.W. Johnson. Margaret retained ownership of the remaining 51 percent interest. At that time, Bruce and Donald assumed the vice president role and, together with Margaret, constituted the board of directors of H.W. Johnson.

H.W. Johnson revenue increased rapidly from the management of Bruce and Donald from approximately $3.9 million in 1993 to $23.8 million and $38.0 million in 2003 and 2004, respectively. During the years in question (2003 and 2004), H.W. Johnson was one of the largest sidewalk, curb, and gutter concrete contractors in Arizona, employing approximately 200 people.

During the years in question, Bruce and Donald worked 10 to 12 hours per day for five to six days per week. H.W. Johnson had an excellent reputation and was known for delivering a quality and timely work product. The concrete work supervised by Bruce and Donald required technical skill and coordination. If the wet concrete reached 90 degrees it would "set," and keeping concrete at a low temperature was challenging in the hot climate of Phoenix, Arizona.

H.W. Johnson compensated Bruce and Donald a total of $4.0 million in 2003 and $7.3 million in 2004. Compensation was based on an officer's bonus formula structured as a tiered percentage of revenue.

Upon review of the H.W. Johnson income tax returns for 2003 and 2004, the Service issued a notice of deficiency stating that the officers' compensation deductions exceeded reasonable compensation by $2.6 million and $5.6 million in 2003 and 2004, respectively.

The Service subsequently changed its position and stated that the officers' compensation exceeded reasonable compensation limits by $811,000 and $769,000 in 2003 and 2004, respectively. H.W. Johnson petitioned the U.S. Tax Court for review.

According to the decision, "The Court of Appeals for the Ninth Circuit . . . applies five factors to determine the reasonableness of executive compensation . . .":

1. The role of employees in the company
2. A comparison of compensation paid by similar companies for similar services
3. The character and condition of the company
4. Potential conflicts of interest
5. The internal consistency of compensation arrangements[7]

The Tax Court separately analyzed and discussed each of these five factors to determine whether the aforementioned compensation paid to Bruce and Donald was reasonable.

Factor #1: The Role of Employees in the Company

The first factor is used by the Tax Court to identify whether the recipient is integral to the success of a company. This factor considers the role of the employee with regard to the position, duties performed, and hours worked.

The Tax Court noted that Bruce and Donald were responsible for contract billing, onsite management and personnel supervision, and equipment modifications. Bruce and Donald were known to have a hands-on management style, through which annual revenue increased from approximately $3.9 million to over $38.0 million in 11 years.

The Tax Court indicated that the evidence presented with regard to the first factor supported the reasonableness of the disputed compensation.

Factor #2: Comparison of Compensation Paid by Similar Companies for Similar Services

The second factor is used to provide an indication of an officer's compensation within a particular industry. The Service acknowledged that the performance of Bruce and Donald was so superior to the performance of executives employed by other companies that a meaningful comparison was not possible.

Therefore, the Tax Court concluded that this factor was neutral with regard to the reasonableness of the disputed compensation.

Factor #3: Character and Condition of the Company

The third factor focuses on the size and complexity of the company as well as the economic conditions affecting it. The Tax Court noted that the H.W. Johnson revenue, profit margins, and total assets had increased significantly from the management by Bruce and Donald.

The Tax Court indicated that the third factor supported the reasonableness of the disputed compensation.

Factor #4: Potential Conflicts of Interest

The fourth factor refers to the independent investor test. As previously discussed, the independent investor test evaluates the reasonableness of shareholder/executive compensation from the perspective of a hypothetical independent investor who would demand a reasonable return on equity ("ROE") after payment of the disputed compensation.

The Tax Court recognized that this factor required particular scrutiny as the controlling shareholder, Margaret, was the mother of Bruce and Donald. The Service and H.W. Johnson both retained expert witnesses to support their positions.

The expert witness retained by the Service analyzed ROE ratios using four sources. The Service expert witness calculated the ROE of seven guideline publicly traded companies.

However, the Tax Court found that the seven guideline publicly traded companies were not sufficiently comparable. This is because these companies:

1. were publicly traded while H.W. Johnson was privately owned,
2. operated in different industries than H.W. Johnson, and
3. generated significantly higher revenue than H.W. Johnson.

The second source that the Service expert witness relied on to calculate ROE was the Risk Management Association ("RMA"). However, for the purposes of this case, the Tax Court found that the RMA data were unreliable because RMA stated that its data should be only used as "general guidelines and not as industry norms." Additionally, RMA stated that the data may include small sample sizes for certain industries.

Third, the Service expert witness calculated ROE based on the Construction Financial Management Association annual financial survey. Likewise, the Tax Court found that these data were not comparable, because many of the companies in the data sample operated in dissimilar industries.

Fourth, the Service expert witness relied on ROE ratios published by Ibbotson Associates. The Tax Court also found that these data were not comparable, because many of the companies in this data set operated within the concrete industry as a whole, and not specifically the concrete contracting sector.

The H.W. Johnson expert witness relied on ROE data from Integra Information ("Integra") for 33 companies that (1) were classified in SIC code 1771, concrete work, and (2) generated revenue between $25 million and $50 million.

The H.W. Johnson expert witness calculated an average pretax ROE of these 33 companies of 10.5 percent and 10.9 percent in 2003 and 2004, respectively.

The Tax Court determined that the companies used by Integra to calculate ROE ratios were sufficiently similar to H.W. Johnson. Further, the Tax Court found that the average pretax ROE from these companies was reasonably similar to the average pretax ROE for H.W. Johnson of 10.2 percent and 9.0 percent in 2003 and 2004, respectively.

The Tax Court ruled that the H.W. Johnson ROE (1) was comparable to the industry average ROE and (2) would satisfy a potential investor.

Accordingly, the Tax Court concluded that the fourth factor supported the reasonableness of the disputed compensation.

Factor #5: Internal Consistency of Compensation Arrangements

The fifth factor refers to whether the disputed compensation was paid in adherence with a structured, formal, and consistently applied compensation program.

That is, application of the fifth factor considers whether compensation is awarded based on (1) clearly stated criteria or (2) ambiguous or undocumented criteria that may allow taxpayers to utilize compensation structures to achieve other goals such as minimizing tax implications.

The disputed compensation paid to Bruce and Donald was a consistently applied, structured, and formal officer's bonus formula. Accordingly, the Tax Court ruled that the fifth factor supported the reasonableness of the disputed compensation.

In summary, based on consideration of the five factors discussed above, the Tax Court concluded that the compensation paid by H.W. Johnson to Bruce and Donald in 2003 and 2004 was reasonable and, therefore, deductible under Section 162(a).

Transupport, Incorporated v. Commissioner

In *Transupport, Incorporated v. Commissioner*,[8] the Tax Court considered the reasonableness of compensation paid to the shareholder president of Transupport, Incorporated ("Transupport"), and his four shareholder sons. The Tax Court ultimately rejected the analysis of one compensation expert in this case due to the perceived lack of independence and objectivity in his analysis.

Transupport was founded in 1972 by Harold Foote. Transupport purchases aircraft engines and engine parts from the government in bulk quantities and resells them for use in helicopters, airplanes, and tanks.

On August 8, 2005, Harold transferred 2,250 shares of Class B nonvoting common stock to each of his four sons—William, Kenneth, Richard, and Jeffrey (collectively, the "Sons"). After this transfer, Harold owned all of the Class A voting common stock and the Sons owned all the Class B nonvoting common stock.

Harold and the Sons were the only full-time employees

of Transupport from 2006 to 2008, which are the years in dispute. Harold was the president and chief executive officer of Transupport. The Sons performed overlapping duties related to the operation of Transupport. The Tax Court noted that some of the duties could have been performed by lower-level employees.

Compensation for Harold was $353,211 in 2006, $478,993 in 2007, and $599,858 in 2008. From 1999 through 2008, each of the Sons was compensated equally. Compensation for each of the Sons was $575,000 in 2006, $675,000 in 2007, and $720,000 in 2008.

Harold compensated each of the Sons equally to avoid preferential treatment, and he did not consult any independent consultants to determine their compensation.

In 2007, Harold began soliciting potential purchasers of Transupport and entered into a nondisclosure agreement with Richard Lodigiani of BTS New England, Inc. Lodigiani prepared a confidential offering memorandum and distributed it to several potential purchasers.

The confidential offering memorandum included a recast financial summary that stated, “Five shareholder salaries recast to market rate of $50,000 annually each.” Additionally, it discussed gross profit expectations and inventory values that were notably different than the financial performance indicated on the Transupport income tax returns.

The confidential offering memorandum was distributed to potential purchasers, including Peter LaHaise. LaHaise then provided the confidential offering memorandum and recast financial summary to the Service through the IRS Whistleblower Office and sought a $13 million whistleblower award.

On January 20, 2009, the Service began an audit of the Transupport income tax return for 2006 and 2007. In October 2009, the audit was expanded to include income tax returns for 1999 through 2005.

In the Tax Court’s prior decision,[10] it held that deficiencies determined from 1999 through 2005 were barred by the statute of limitations because the Service failed to prove that underpayments from 1999 through 2005 were due to fraudulent intent.

The Service retained a forensic analyst to provide a reasonable compensation analysis to support the audit. The forensic analyst did not interview the Sons. His investigation included a review of the following:

1. Transupport 2006 income tax return
2. Resumes of the Sons
3. A general description of the business

His analysis was based on data from ERI. The Service forensic analyst relied on the NAICS code provided in the Transupport 2006 tax return, which was 423990, Other Miscellaneous Durable Goods Merchant Wholesalers, within the heading “Wholesale Trade.” The forensic analyst then refined his search to include only aircraft parts manufacturers.

The Service forensic analyst concluded a reasonable compensation for the Sons in 2006 based on the median compensation provided by ERI. He concluded that reasonable compensation in 2006 was $250,000 for Richard (one of the Sons) and $225,000 for each of the other Sons. To estimate reasonable compensation in 2007 and 2008, he increased the compensation in 2006 by 3 percent per year.

Additionally, the forensic analyst concluded that compensation for Harold was reasonable in 2006, and he normalized salary increases to 3 percent per year in 2007 and 2008 for Harold.

The Tax Court noted that the companies selected by the Service forensic analyst (i.e., aircraft parts manufacturers) did not include any wholesalers such as Transupport.

Transupport petitioned for a redetermination of income tax deficiencies and penalties arising from the aforementioned adjustments to employee compensation. Transupport retained a forensic analyst to perform a reasonable compensation analysis.

The Transupport forensic analyst also relied on a single database that included manufacturers rather than wholesalers. He estimated reasonable compensation at the 90th percentile of the selected compensation data set.

The Tax Court noted that the compensation analysis performed by the Transupport forensic analyst was flawed because his analysis aimed to “validate and confirm that the amounts reported on [the Transupport] tax returns were correct” rather than to estimate reasonable compensation.[11] That is, the forensic analyst acted as an advocate rather than as an independent consultant.

Additionally, the Tax Court noted that the forensic analyst (1) only considered one database and (2) relied on compensation at or near the high end of the data set—despite the Sons’ lack of the relevant skills to perform the duties successfully.

In trial, the Service did not rely on the forensic analyst that it initially had retained, but instead retained a second compensation analyst.

The second forensic analyst of the Service relied on compensation data for wholesalers rather than manufacturers. He performed five different analyses based on five databases and relied on the median

of the compensation data. He concluded that the salary paid to Harold was reasonable because it approximated the median of the selected databases. However, the Service forensic analyst did not discretely estimate the Sons salaries.

Due to the overlapping duties of the Sons, the second forensic analyst estimated one single compensation total for Harold and the Sons. He concluded a reasonable level of compensation that was lower than the amounts indicated in the notice of deficiency.

In summary, the Tax Court found that compensation analyses from the forensic analysts for the Service were flawed. The Tax Court noted that the second forensic analyst did not separately estimate compensation for Harold, which decreased the credibility of his analysis—if compensation for Harold was removed from the estimated total compensation, the remaining compensation for the Sons would actually decrease from 2006 to 2008.

The indicated decrease in compensation was contrary to the actual financial performance of Transupport, weakening the credibility of the conclusions of the second forensic analyst. That is, the residual compensation for the Sons (after removing compensation for Harold) decreased from 2006 to 2008 while sales had increased for the company.

Further, the Service forensic analysts did not interview Harold and his Sons as part of the engagement, which was another weakness noted by the Tax Court.

The Tax Court found that the reasonable compensation analyses performed by the Transupport forensic analyst lacked objectivity and independence.

The Tax Court stated, "In most cases, as in this one, there is no dispute about the qualifications of the experts. The problem is created by their willingness to use their resumes and their skills to advocate the position of the party who employs them without regard to objective and relevant facts, which is contrary to their professional obligations."[12]

The Tax Court also noted, "An expert is not helpful to the court and loses credibility when giving testimony tainted by overzealous advocacy."[13]

Despite the acknowledged flaws, the Tax Court concluded that the approach of the first forensic analyst for the Service was rational and not arbitrary. Therefore, the Tax Court concluded that reasonable compensation for Harold and his Sons was equal to the amounts indicated in the notice of deficiency.

Brinks Gilson & Lione v. Commissioner

In *Brinks Gilson & Lione, a Professional Corporation, v. Commissioner*,[14] the Tax Court applied the independent investor test to test the reasonableness of compensation paid in the form of year-end bonuses to shareholder attorneys, which reduced reported income to $0.

The Tax Court disallowed a portion of the disputed compensation and held Brinks Gilson & Lione ("BGL") responsible for an accuracy-related penalty related to the underpayment of income taxes resulting from the overpayment of shareholder attorney compensation.

BGL is an intellectual property law firm organized as a corporation. It is based in Chicago, Illinois. During the years in question (2007 and 2008), it employed approximately 150 attorneys and an additional staff of 270 employees. Approximately 65 of the attorneys were shareholders.

At BGL, shareholder attorneys acquire their equity shares at a price equal to book value. And, upon termination of employment, shareholder attorneys are required to sell their shares back to the firm at a price equal to book value.

At the end of each year, shareholder attorneys receive a bonus. During the years in question, BGL reported the bonuses as part of employee compensation in the preparation of its tax returns. Total shareholder attorney bonuses were $9.0 million and $13.7 million in 2007 and 2008, respectively.

The Tax Court indicated that it was the intent of the board of directors of BGL that the sum of the shareholder attorneys' bonuses exhausts book income. That is, total expenses were intended to exactly equal revenue, and book income was intended to be $0.

BGL shareholder attorneys also are entitled to receive dividends. However, for at least the 10 years preceding the years in issue, BGL had not paid any dividends.

Upon a review of the BGL 2007 and 2008 income tax returns, the Service disallowed various BGL expense deductions, including the year-end bonuses paid to shareholder attorneys.

After negotiations, BGL and the Service agreed that portions of the disputed compensation for the years in issue would be disallowed and reclassified as dividends. The disallowed portion of compensation (i.e., part of the shareholder attorney bonuses) were $1.6 million and $1.9 million in 2007 and 2008, respectively. The issue in this case was whether BGL was liable for accuracy-related penalties on the underpayment of its income tax.

The Tax Court considered the independent investor test in this shareholder attorney compensation dispute. BGL argued that the independent investor test was not relevant in this case. BGL argued that the shareholder attorneys lack the rights of equity owners because they acquire stock at book value

upon commencement of employment and surrender stock at book value upon termination of employment.

BGL claimed that this arrangement would not actually constitute a transference of an equity ownership interest. And, with regard to the independent investor test, BGL suggested that consequently all payments to shareholder attorneys should, therefore, be treated as compensation rather than as a return on equity.

The Tax Court held that the acquisition and sale of stock through a formula based on book value does not relinquish the shareholder attorneys' right to a return on their investments. The Tax Court concluded the independent investor test was a relevant test in determining the reasonableness of the disputed shareholder attorney compensation.

The Tax Court stated, "Ostensible compensation payments made to shareholder employees by a corporation with significant capital that zero out the corporation's income and leave no return on the shareholders' investments fail the independent investor test."[15]

The BGL reported book value of equity was $8.0 million and $9.3 million as of December 31, 2007 and 2008, respectively.

The Tax Court stated that an independent investor in BGL would not have forgone a return on equity through the bonus structure that eliminated book income. Therefore, the Tax Court concluded that the reported shareholder attorney compensation failed the independent investor test.

In summary, the Tax Court considered whether guidance (e.g., the independent investor test, relevant statutes, and judicial precedent) supported or were contrary to the deduction of shareholder bonuses as compensation.

The Tax Court concluded that BGL did not demonstrate reasonable cause for deducting the disputed bonuses as compensation, or that it had acted in good faith regarding the compensation deduction.

Conclusion

The days when C corporations and S corporations can arbitrarily determine shareholder/executive compensation have passed. Due to the significant amount of money involved, the Service is increasingly scrutinizing the reported shareholder/executive compensation of C corporations and S corporations.

If audited—and if the Service and Tax Court find that shareholder/executive compensation was disproportionate and not based on the fair market value of the services rendered—then the taxpayer company potentially can incur a substantial penalty.

Retaining a qualified forensic analyst may be beneficial to reasonable shareholder/executive compensation. The recent judicial decisions summarized above underscore the importance of retaining a qualified, independent forensic analyst to prepare reasonable compensation analyses.

To estimate reasonable shareholder/executive compensation, the forensic analyst should consider relevant federal tax statutes, judicial guidance, and market-based compensation data of job positions at comparable companies.

Notes:

1. Mayson Manufacturing Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949).
2. Pulsar Components International, Inc. v. Commissioner, T.C. Memo. 1996-129 (March 14, 1996).
3. Trucks, Inc. v. U.S., 588 F. Supp. 638 (D.C. Neb. 1984).
4. Elliotts, Inc. v. Commissioner, T.C. Memo. 1984-516 (September 27 1984).
5. Scott R. Miller and Charlene M. Blalock, "Compensation Adjustments in Business Valuations for Family Law Disputes," *American Journal of Family Law* (Spring 2017): 3-13.
6. H.W. Johnson, Inc., v. Commissioner, T.C. Memo. 2016-95 (May 11, 2016).
7. H.W. Johnson, Inc., T.C. Memo. 2016-95 at *5.
8. Transupport, Incorporated v. Commissioner, T.C. Memo. 2016-216 (November 23, 2016).
9. Transupport, Incorporated v. Commissioner also considered discrepancies and errors related to cost of goods sold and inventory accounting practices. At the time of publication of this article, this case was under appeal.
10. Transupport, Incorporated, T.C. Memo. 2015-179.
11. Id. at *9.
12. Id. at *6.
13. Id.
14. Brinks Gilson & Lione a Professional Corporation v. Commissioner, T.C. Memo. 2016-20 (February 10, 2016).
15. Id. at *5.

Casey D. Karlsen is an associate in our Portland, Oregon, office. He can be reached at (503) 243-7513 or at cdkarlsen@willamette.com.

Lisa Tran is a vice president in our Portland office. She can be reached at (503) 243-7510 or at lhtran@willamette.com.