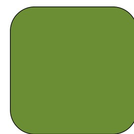

REASONABLENESS OF COMPENSATION GUIDANCE FOR CONSTRUCTION INDUSTRY TAXPAYERS

In the construction industry — and in any industry, for that matter — documentation of actual facts and circumstances helps the taxpayer win the day.

ROBERT F. REILLY

The IRS often challenges the reasonableness of the total amount of compensation that is paid to the shareholders/employees of closely held C corporations. This statement is particularly true for closely held contractors that operate in the various segments of the construction industry. Due to the vagaries of the industry, construction company revenue and profits are often cyclical. The IRS often states that any alleged excess compensation amounts (particularly in profitable years) are not tax deductible compensation payments at all. Rather, the IRS claims that such payments are disguised — and nondeductible — dividend payments. Excess compensation amounts are the amounts that the closely held company pays to the shareholder/employer in excess of what comparable employees would be paid at comparable companies.

The United States Tax Court decision in *H.W. Johnson, Inc. v. Commissioner of Internal Revenue* (hereafter the *H.W. Johnson, Inc.* decision) provides recent guidance as to how the courts analyze the reasonableness of shareholder/employee compensation — particularly for construction industry taxpayers.[1] Although the *H.W. Johnson, Inc.* decision is only a memorandum decision, it is 32 pages in length. Accordingly, this published judicial decision provides a fair amount of discussion regarding the court's rationale in this case. In summary, the *H.W. Johnson, Inc.* decision is very taxpayer friendly. As discussed here, the judicial decision was influenced by the testimony of com-

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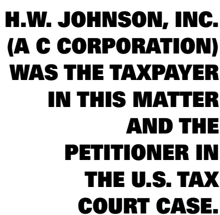
peting forensic analyst testifying experts. Moreover, both the experts' forensic analyses and the court's judicial decision are heavily influenced by the specific facts and circumstances surrounding this particular construction industry taxpayer.

The tax issues in the dispute

H.W. Johnson, Inc. (a C corporation) was the taxpayer in this matter and the petitioner in the U.S. Tax Court case. The IRS determined deficiencies in the taxpayer's federal income tax for the taxable years ending June 30, 2003, and June 30, 2004 (the years at issue), of $877,440 and $2,087,678, respectively. The particular tax problems that the Tax Court decided were:

- whether the amounts paid to shareholders/employees Bruce A. Johnson and Donald J. Johnson during the years at issue were considered reasonable compensation and deductible under Internal Revenue Code Section 162; and
- whether the taxpayer was entitled to deduct a $500,000 payment made in 2004 to DBJ Enterprises, LLC (hereafter DBJ), an entity controlled by Bruce and Donald, as an ordinary and necessary business expense under Section 162.



H.W. JOHNSON, INC. (A C CORPORATION) WAS THE TAXPAYER IN THIS MATTER AND THE PETITIONER IN THE U.S. TAX COURT CASE.

Background on H.W. Johnson, Inc.

During the years at issue, H.W. Johnson, Inc. operated a concrete contracting business. At that time, the company was one of the largest curb, gutter, and sidewalk contractors in the state of Arizona. The company had more than 200 employees, and it earned contract revenue of $23,754,182 and $38,022,612 in 2003 and 2004, respectively.

The company was incorporated in 1974 by H.W. Johnson and his wife Margaret Johnson. H.W. and Margaret had operated a predecessor sole proprietorship out of their home since 1968. Since the company's founding, H.W. had managed all of the company operations, and Margaret had managed all of the company financial and administrative matters.

Two of the Johnson sons, Bruce and Donald, began working part time for the company as teenagers in the 1970s. The sons worked full time for the company after they completed their education in 1977 and 1982, respectively. Bruce and Donald gradually assumed increasing management responsibilities and took over the company daily operations in 1993. H.W. and Margaret made gifts of shares of the company stock to Bruce and Donald. By 1996, when H.W. retired from H.W. Johnson, Inc., Bruce and Donald each owned 24.5 percent of the shares, with Margaret retaining the remaining 51 percent of the shares. Upon the retirement of H.W., the two brothers became co-vice presidents and members (along with Margaret) of the company board of directors.

The construction company revenue increased rapidly after Bruce and Donald assumed control of the H.W. Johnson, Inc. operations in 1993.That year, the company reported revenue of approximately $4 million. Company revenue increased to more than $11 million and $13 million in 1994 and 1995, respectively.

The construction company revenue remained steady at about $17 million between 1996 and 1999 and increased consistently every year thereafter, including in the years at issue. In fact, the construction company revenue increased dramatically between 2003 and 2004.

H.W. Johnson, Inc. was profitable and experienced significant revenue and asset growth during 2003 and 2004, with gross profit margins (before payment of officer bonuses) of 38.3 percent and 38.2 percent, respectively. The H.W. Johnson, Inc. assets, liabilities, equity, revenue, net income before taxes, and net income after taxes from 2002 to 2004 are reported in Exhibit 1.

During the years at issue, shareholders/employees Bruce and Donald personally guaranteed the company loans. The company used the loan proceeds to purchase materials and supplies.

The tax years at issue: 2003 and 2004

During the years at issue, Margaret served as the company president and chairman of the board. Margaret managed the company payroll and finances, accounts

EXHIBIT 1 H.W. Johnson, Inc. Results of Operations for Years 2002–2004

Financial Fundamental	2002	2003	2004
Assets	$6,814,399	$8,844,769	$13,424,705
Liabilities	3,228,649	5,058,551	9,536,121
Equity	3,585,750	3,786,218	3,888,584
Contract Revenue	23,239,207	23,754,182	38,022,612
Net Income Before Taxes	210,967	387,706	348,579
Net Income After Taxes	132,545	250,468	202,366

receivable and delinquent account collections, employee hiring and terminations, and various other administrative functions, working approximately 40 hours per week. Together Bruce and Donald managed all operational aspects of the company business. The company operations were split into two geographical divisions: eastern and western. Each brother managed one division's operations, including contract bidding and negotiation, project scheduling and management, equipment purchases and modification, personnel management, and customer relations.

Bruce and Donald each supervised more than 100 employees in their respective divisions, including superintendents and foremen. The two brothers worked between 10 and 12 hours per day, five to six days per week. They were at the jobsites daily, and they regularly operated equipment while there. They were also readily available if problems occurred at a jobsite. Furthermore, Bruce and Donald were known in the local construction industry for their responsive and hands-on management style.

During the years at issue, approximately 95 percent of H.W. Johnson, Inc. business was related to residential subdivision construction. The concrete work that Bruce and Donald supervised required considerable technical skill and coordination. This is because fresh concrete is highly perishable. That is, concrete "sets" — and becomes unusable — either (1) 90 minutes after it is mixed and loaded onto a truck or (2) if it reaches a temperature of 90 degrees.

H.W. Johnson, Inc. had to meet the varying specifications of different contractors, engineers, cities, towns, and counties on any given job. The company equipment was often modified or specially fabricated to meet the requirements of a given job. Most of that work was performed in-house — thereby reducing costs and improving efficiency — with Bruce or Donald often supplying the idea for a design that was then refined and implemented by the company fabrication foreman.

H.W. Johnson, Inc. enjoyed an excellent reputation with developers, inspectors, and other contactors, and it was known for its timely performance and quality product. As a result, the company was routinely awarded contracts even where it was not the lowest bidder. The company needed little marketing beyond its reputation in the local construction market.

DBJ Enterprises, LLC

A reliable supply of concrete was critical to the company. H.W. Johnson, Inc. did not produce its own concrete, instead relying on local suppliers. Starting in late 2002 and throughout the years at issue, there were shortages of concrete in the company's market due to a housing boom in Arizona. In addition, large multinational and national construction companies were acquiring suppliers of concrete in Arizona, disrupting the locally based network.

Faced with the possibility of disruptions in the petitioner's supply of con-

EXHIBIT 2 Shareholder/Employee Total Compensation for the Years 2003 and 2004

Company Officer	2003	2004
Bruce	$2,013,250	$3,651,177
Donald	2,011,789	3,649,739
Total	4,025,039	7,300,916

crete, Bruce and Donald suggested to Margaret that H.W. Johnson, Inc. invest in a concrete supplier (in order to have a reliable supply). As the controlling shareholder, Margaret refused to involve the company in such a venture because she considered it to be too risky.

On March 21, 2003, Bruce and Donald, acting through DBJ, partnered with other investors (including a former executive of a local concrete supplier that had been acquired by a large multinational company) to form Arizona Materials, LLC (hereafter Arizona Materials). Arizona Materials was formed to conduct a concrete supply business. DBJ owned a 52 percent equity interest in Arizona Materials. Through DBJ, Bruce and Donald invested substantial sums in, and guaranteed the indebtedness of, Arizona Materials.

There were occasional market shortages of cement — an essential ingredient of concrete — during the years at issue. Arizona Materials was able to obtain access to cement during that period because of its relationship with other cement suppliers. H.W. Johnson, Inc. obtained a substantial amount of concrete from Arizona Materials during 2004. Moreover, H.W. Johnson, Inc. was able to procure concrete even when other contractors could not (and were, therefore, forced to temporarily suspend operations).

H.W. Johnson, Inc. received bulk discounts for large concrete purchases from Arizona Materials, obtaining concrete at a price lower than it paid to other suppliers. DBJ exercised its influence as majority shareholder of Arizona Materials to ensure that H.W. Johnson, Inc. received a steady supply of concrete. (At that time, Arizona Materials had other customers who were willing to pay a higher price for the concrete.)

The shareholder/employee compensation issue

At the end of 2004, H.W. Johnson, Inc. paid DBJ $500,000. The H.W. Johnson, Inc. board meeting minutes state that the payment was for a "guaranteed supply of concrete at market prices for the year ended June 30, 2004. DBJ has negotiated with Arizona Materials L.L.C. on behalf of H.W. Johnson, Inc. to provide a continuous supply of concrete."[2] The IRS noted that H.W. Johnson, Inc. and DBJ had no written agreement regarding the $500,000 payment.

During the years at issue, the H.W. Johnson, Inc. board held annual meetings in May to determine officer compensation, director's fees, and dividends. For those years, the company compensated Bruce and Donald as shown in Exhibit 2.

The H.W. Johnson, Inc. officer bonus formula was adopted by the company board in 1991, and it was amended in 1999. The total potential bonuses were calculated in proportion to the company's annual contract revenue and added to a "bonus pool." At the end of the year and upon the advice of the company accountant, the board of directors issued bonuses out of the bonus pool based on (1) officer performance and (2) the company's ability to pay. Any unpaid amounts remained in the bonus pool for later payment, pending board approval.

During the years at issue, H.W. Johnson, Inc. had a dividend plan, which was adopted in 1991 and amended in 1999. That plan called for dividend payments when the company retained earnings balance exceeded $2 million. The company board determined the amount of the dividend on the basis of the company financial position, profitability, and capitalization, following the advice of the company accountant.

H.W. Johnson, Inc. paid modest dividends to its shareholders between 1996 and 2004. For most of those years, the dividend amount was $25,000. In 2002 and 2003, the dividend amount increased to $50,000. In 2004, the dividend amount was $100,000.

The audit and the tax deficiency

On a timely filed Form 1120, U.S. Corporation Income Tax Return, for 2003 and 2004, H.W. Johnson, Inc. claimed tax deductions for the salaries, bonuses, and director fees paid to Margaret, Bruce, and Donald. The construction company also claimed a deduction for 2004 for the $500,000 that it paid to DBJ, reporting the payment as an "administration fees" expense.

The IRS issued a notice of deficiency to H.W. Johnson, Inc., determining that $2,607,517 and $5,616,771 of the amounts the company deducted for 2003 and 2004, respectively, as officer compensation exceeded so-called reasonable compensation. The IRS also disallowed in its entirety the $500,000 deduction that the company claimed for 2004 as administration fees.

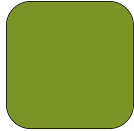
The Tax Court analysis

At trial, the IRS concluded that deductions of $3,214,000 and $6,532,000 for shareholder/employee compensation were reasonable, leaving $811,039 and $768,916 as excess compensation amounts in dispute for 2003 and 2004, respectively.

The Tax Court noted that Section 162(a)(1) allows a taxpayer to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered" as an ordinary and necessary business expense. The taxpayer is entitled to a deduction for compensation payments if the payments (1) are reasonable in amount and (2) are paid purely for services. Although framed as a two-pronged test, courts considering the deductibility of shareholder/employee compensation under Section 162(a)(1) typically focus only on whether the com-

pensation amount is reasonable (see *Elliotts, Inc. v. Commissioner*).[3] In the *H.W. Johnson, Inc.* case, the taxpayer had the burden of proving that the amounts paid to shareholders/employees Bruce and Donald in 2003 and 2004 were reasonable.

The Tax Court noted that the Court of Appeals for the Ninth Circuit (to which an appeal of this decision would be made) applies the following five factors to determine the reasonableness of compensation, with no one factor being determinative: (1) the employee's role 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, and (5) the internal consistency of compensation arrangements. These are the so-called "five factors" described in *Elliotts v. Commissioner*.[4]



THE TAX COURT CONCLUDED THAT THE INDUSTRY DATA ON WHICH THE IRS ANALYST RELIED WAS NOT AS ACCURATE AS THE INDUSTRY DATA USED BY THE COMPANY'S ANALYST.

In analyzing the fourth factor, the Court of Appeals emphasizes evaluating the reasonableness of shareholder/employee compensation payments from the perspective of a hypothetical independent investor, focusing on whether the investor would receive a reasonable return on equity after payment of the shareholder/employee compensation. This so-called "independent investor test" is described in the *Elliotts* decision and in *Metro Leasing Dev. Corp. v. Commissioner*.[5]

At trial, both parties introduced expert witness reports and analyst testimony to support their respective positions.

The IRS effectively conceded four of the five *Elliotts* factors tend to support, or are at least neutral with respect to, the reasonableness of the shareholder/employee compensation paid by H.W. Johnson, Inc. Nonetheless, the IRS argued that the subject case hinged on the fourth *Elliotts* factor: namely, whether a hypothetical independent investor would receive an adequate return on equity after accounting for the compensation paid to Bruce and Donald. Accordingly, the Tax Court considered each of the *Elliotts* factors, but it focused on the independent investor test factor.

The independent investor test. The Tax Court noted that the Ninth Circuit approached the fourth *Elliotts* factor by evaluating the compensation payments from the perspective of a hypothetical independent investor, focusing on the investor's return on equity. If the subject company return on equity (after payment of the shareholder/employee compensation) remains at a level that would satisfy an independent investor, there is strong evidence (1) that the shareholder/employee is providing compensable services and (2) that the company's profit-related dividends are not being disguised as salary.

In the subject case, both expert analysts agreed that H.W. Johnson, Inc. earned pretax returns on equity of 10.2 percent and 9 percent for 2003 and 2004, respectively. The analysts differed, however, on what a required return on equity should be for the subject construction company.

The IRS analyst used return on equity data from four sources that indicated a sufficient return on equity ranging from 13.8 percent to 18.3 percent. The Tax Court concluded that the industry data on which the IRS analyst relied was not as accurate as the industry data used by the company's analyst.

The IRS analyst's first return on equity (ROE) indication was derived from seven selected "guideline companies." The Tax Court concluded that the guideline companies were not sufficiently comparable to H.W. Johnson, Inc. because "they were publicly traded, operated in industries different from petitioner's, and had gross sales substantially larger than petitioner's." The IRS analyst's second ROE indication was derived from industry data in an annual statement published by the Risk Management Association. The Tax Court noted that the publication itself states that its data should be used "only as general guidelines and not as absolute industry norms." This is because the data "may not be fully representative of a given industry" for several reasons, including that (1) it is not randomly selected and (2) it may include small sample sizes for certain industries.

The IRS analyst's third ROE indication was derived from the Construction Financial Management Association annual

financial survey. The Tax Court noted that "many of the companies in that data sample operated in industries dissimilar from petitioner's."

Finally, the IRS analyst derived a "market required return on equity" from data published by Ibbotson Associates. The Tax Court was concerned because "that data is from companies engaged in the construction industry generally, not the concrete contracting sector of which petitioner is a part."

The company's analyst used ROE indications derived from Integra Information (Integra) data. Integra is a data service that compiles financial information of privately held companies from government and other sources. The company's analyst used Integra data from 33 companies in Standard Industrial Classification code 1771, construction — special trade contractors — concrete work, with revenue ranging from $25 million to $49,999,999.

The Tax Court noted: "We find the companies that petitioner's expert used to be more comparable to petitioner for purposes of a return on equity analysis than those used by respondent's expert."[6]

The company's analyst calculated an average pretax ROE from these 33 companies of 10.5 percent and 10.9 percent for calendar years 2003 and 2004, respectively. Accordingly, the actual H.W. Johnson, Inc. pretax ROE was 0.3 percentage points below the Integra companies' average ROE in 2003 and 1.9 percentage points below the Integra companies' average ROE in 2004.

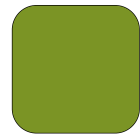
Of course, the parties disagreed about whether H.W. Johnson, Inc. "passed" the independent investor test — even based on the company analyst's ROE conclusions. At trial, the IRS argued that, because the company ROE was slightly below the industry average ROE in 2003 and 2004, Bruce and Donald were unreasonably compensated in those years. An independent investor would have required an ROE that was more commensurate with the company's superior performance, the IRS claimed. The company maintained that its actual ROE was generally in line with the industry average and, therefore, H.W. Johnson, Inc. had satisfied the independent investor test.

The Tax Court concluded: "We agree with petitioner." The IRS produced no authority for its position that the required ROE for purposes of the independent investor test must significantly exceed the industry average ROE, particularly when the subject company has been financially successful.

The Tax Court's decision stated: "We consequently find that petitioner's returns on equity of 10.2 percent and 9 percent for 2003 and 2004, respectively, tend to show that the compensation paid to Donald and Bruce for those years was reasonable. As petitioner's expert points out, mere reductions in their collective compensation of $9,847 and $75,277 in 2003 and 2004, respectively — differences of approximately 1 percent — would have placed petitioner's return on equity at exactly the average for comparable companies in the concrete business. Consequently, this factor favors a finding that the compensation at issue was reasonable."[7]

In summary, the *Elliotts* factors supported the conclusion that the compensation the construction company paid to Bruce and Donald in 2003 and 2004 was reasonable. The brothers were integral to the company's successful performance — a performance that included growth in revenue, assets, and gross profit margins during the disputed years. Therefore, the Tax Court concluded: "The return on equity petitioner generated for each year after payment of Bruce's and Donald's compensation was in line with — indeed closely approximately — the return generated by the companies most comparable to it. We accordingly conclude that an independent investor would have been satisfied with the return. For these reasons, we hold that the $4,025,039 and $7,300,916 petitioner paid as officer compensation in 2003 and 2004, respectively, were reasonable and therefore deductible under Section 162(a)(1)."[8]

The DBJ payment. In addition, the Tax Court had to decide whether H.W. Johnson, Inc. could deduct the $500,000 "administration fees" expense paid to



THE *ELLIOTTS* FACTORS SUPPORTED THE CONCLUSION THAT THE COMPENSATION THE CONSTRUCTION COMPANY PAID TO BRUCE AND DONALD IN 2003 AND 2004 WAS REASONABLE.

DBJ and reported on its 2004 tax return as a business expense.

The company argued that the $500,000 "administration fees" expense was an ordinary and necessary business expense. The company also argued that the payment was made to DBJ for securing a guaranteed supply of concrete, discounted for bulk purchases, from Arizona Materials during 2004. In contrast, the IRS argued that the $500,000 payment was not an ordinary and necessary business expense and:

- there was no written contract or evidence of any oral agreement obligating petitioner to compensate DBJ, and, therefore, the $500,000 payment was voluntary;
- DBJ performed no compensable services on behalf of petitioner; and
- the $500,000 payment was made not for services that DBJ provided, but for services Bruce and Donald performed in their capacities as officers of H.W. Johnson, Inc.

The Tax Court concluded: "Respondent's arguments are unpersuasive."[9] The Tax Court noted that Bruce and Donald, acting through DBJ, used the DBJ controlling position in Arizona Materials to cause Arizona Materials to supply concrete to H.W. Johnson, Inc. during times of shortage at favorable prices. Bruce and Donald, acting in their individual capacities (when their more risk-adverse, controlling-shareholder mother would not allow petitioner to do so), made arrangements to form Arizona Materials to ensure the H.W. Johnson, Inc. concrete supply in the face of looming shortages.

The brothers, again acting in their individual capacities and using DBJ as a vehicle, invested substantially in — and guaranteed the indebtedness of — Arizona Materials. The brothers assumed the risk associated with formation and operation of Arizona Materials in their individual capacities. Therefore, the Tax Court concluded that Bruce and Donald could reasonably expect to be compensated by H.W. Johnson, Inc. for doing so when it substantially benefitted from the fruits of their efforts.

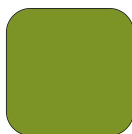
The Tax Court noted: "In view of the foregoing, respondent's contention that petitioner's payment to DBJ was voluntary, given the absence of a written agreement or evidence of an oral agreement to compensate DBJ, is unavailing."

Moreover, the Tax Court concluded: "We are satisfied that petitioner's board, including majority shareholder Margaret, concluded at the close of 2004 that the $500,000 payment to DBJ was appropriate to compensate Bruce and Donald for the substantial benefit they conferred on petitioner in their individual capacities."

The Tax Court decision stated: "In the same vein, we do not agree with respondent that DBJ provided no compensable services to petitioner."

In summary, the Tax Court concluded: "The $500,000 payment petitioner made in consideration of the resulting benefits was therefore earned and received by Bruce and Donald (through DBJ) in their individual capacities."[10]

The Tax Court ruled that the $500,000 payment was an ordinary and necessary expense within the meaning of Section 162(a) because it was normal for a concrete contractor to expend funds to ensure a reliable supply of concrete in the face of shortages. In addition, the expenditure was helpful to the H.W. Johnson, Inc. business, allowing it to meet customer demand when other contractors were hampered by the concrete shortage.



IN THE CONSTRUCTION INDUSTRY — AND IN ANY INDUSTRY FOR THAT MATTER — DOCUMENTATION OF THE ACTUAL FACTS AND CIRCUMSTANCES HELPS THE TAXPAYER WIN THE DAY WITH REGARD TO THE TAX DEDUCTIBILITY OF (1) SHAREHOLDER/ EMPLOYEE COMPENSATION AND (2) RELATED-PARTY PAYMENTS.

Summary and conclusion

The *H.W. Johnson, Inc.* decision is a taxpayer-friendly judicial decision. Of course, the facts and circumstances of the case were very favorable to the taxpayer's position.

First, the Tax Court relied on the *Elliotts* five factors in its reasonableness of shareholder/employee compensation analysis. In particular, the Tax Court relied heavily on the so-called independent investor test.

Second, both the IRS analyst and the taxpayer analyst applied the independent investor test. The Tax Court seemed to be most influenced by the comparability (or lack thereof) of the benchmark industry data used by both analysts to calculate the required ROE measurement.

Third, the Tax Court concluded that the taxpayer company did not have to exactly achieve the industry average ROE calculation. For a financially successful company (like H.W. Johnson, Inc.), achieving an ROE sufficiently close to the industry average statistic was sufficient to "pass" the independent investor test.

Fourth, the Tax Court was impressed with the measurable economic benefit to H.W. Johnson, Inc. associated with the DBJ relationship. Accordingly, the facts and circumstances of the case convinced the Tax Court of the tax deductibility of the DBJ payment.

In the construction industry — and in any industry for that matter — documentation of the actual facts and circumstances helps the taxpayer win the day with regard to the tax deductibility of (1) shareholder/employee compensation and (2) related-party payments. The IRS continues to challenge what it perceives as unreasonable shareholder/employee compensation or unsupportable related-party payments — both with regard to closely held C corporations. However, the closely held company taxpayer (and the taxpayer's legal counsel and forensic analyst) can prevail in a judicial challenge by having the superior factual documentation and the superior empirical analysis. ■

NOTES

[1] *H.W. Johnson, Inc. v. Commissioner of Internal Revenue*, docket number 3110-07. Available at: https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=10799.

[2] *Ibid.*

[3] Internal Revenue Code §162(a)(1); *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1244 (9th Cir. 1983), *rev'g* T.C. Memo. 1980-282.

[4] *Ibid., Elliotts, Inc. v. Commissioner.*

[5] *Metro Leasing Dev. Corp. v. Commissioner*, 376 F.3d 1015, 1019 (9th Cir. 2004), *aff'g* T.C. Memo. 2001-119.

[6] *Op. cit.* note 1.

[7] *Ibid.*

[8] *Op. cit.* note 1.

[9] *Ibid.*

[10] *Op. cit.* note 1.