The Independent Investor Test for Reasonableness of Shareholder/Employee Compensation in Family Law Disputes: Part I of II

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Part I covers non-family law contexts, the reasonable compensation and the first income tax case.

Part II of this article will discuss the second income tax case.

Controversies regarding the reasonableness of owner/employee compensation arise in many family law matters where the marital estate owns a family-owned business or professional practice. This article assumes that all of these ownership interests involve closely held (as opposed to publicly traded) companies. These ownership interests may involve many types of organization structures, such as corporations, limited liability companies, partnerships, and other legal forms. For simplicity purposes only, this discussion refers to all of these types of interests collectively as closely held corporations. Also, this general area of dispute involves the reasonableness of the owner/employee compensation, regardless of the type of owner (member, shareholder, partner, etc.), or the type of business entity. For simplicity, this discussion refers to all types of owner compensation as the reasonableness of shareholder/employee compensation.

This issue typically arises with regard to the valuation of the closely held business ownership interests owned by the marital estate. The outside spouse often claims that the inside spouse is earning excessive shareholder/employee compensation. That excessive compensation causes an understatement of the earnings of the closely held corporation. The understated earnings cause an undervaluation of the closely held corporation. That business valuation understatement causes an undervaluation of the marital assets subject to distribution.

Of course, the allegedly excess compensation has alimony and other support payment implications. The topic of this discussion, however, is assessing the reasonableness of the close corporation shareholder/employee compensation for purposes of valuing that equity interest as part of the marital estate assets.

NONFAMILY LAW CONTEXTS

In addition to family law disputes, the reasonableness of close corporation shareholder/employee compensation is a fairly common issue in controversies related to federal income tax disputes. In addition, other such compensation-related controversies can arise with regard to shareholder breach of fiduciary duty matters, breach of contract matters, ESOP/ERISA matters, and other types of legal disputes.

Outside of the legal controversy arena, the normalization of shareholder/employee compensation is a common analytical procedure when a valuation analyst (analyst) develops the valuation of a controlling ownership interest in a closely held business or professional practice for just about any purpose.

Outside of the family law context, the Internal Revenue Service (Service) may allege that the

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taxable income of a closely held C corporation is understated because of shareholder/employee excess compensation. Alternatively, in the case of S corporations or other tax pass-through entities, the Service may claim that the taxpayer corporation's payroll-related employer taxes are understated because the close corporation pays an unreasonably low level of shareholder/employee compensation.

In shareholder oppression claims, the plaintiffs often allege that they are oppressed because the controlling shareholder withdraws a disproportionate percentage of the closely held corporation earnings in the form of excess compensation. In dissenting shareholder appraisal rights actions, the plaintiffs sometimes allege that the fair value of the acquired company should be greater than the deal transaction price; they claim the transaction price was undervalued because the acquired company earnings were understated; and they claim the acquired company earnings were understated because the controlling shareholder was paid an excessive level of compensation. In any joint venture, license, or other contract where some contract payment term is based on the relative (or absolute) profits of one party, a contract counterparty may claim that the party's profits are understated because of excessive shareholder/employee compensation.

In ESOP/ERISA matters, the ESOP participants (and sometimes the Department of Labor) may claim that the sponsor company earnings available to the ESOP are understated because the controlling (usually founding family) shareholder is paid excess compensation. Effectively, the ESOP participant employees are oppressed because of the alleged excess compensation paid to the non-ESOP (controlling) shareholder/employees.

Outside of the litigation context, analysts typically assess the reasonableness of owner/employee compensation as a regular part of the closely held corporation business valuation. This assessment is commonly performed when a controlling ownership interest business valuation is performed for transaction, taxation, financing, financial accounting, or any other purpose.

The point is that reasonableness of shareholder/employee compensation issues—and the performance of reasonableness of shareholder/employee compensation analyses—are not at all unique to the family law discipline. Much of the reasonableness of compensation professional guidance available to family law counsel and to valuation analysts comes from the federal income tax discipline.

WHAT IS REASONABLE COMPENSATION?

There may be specific statutory or other definitions of reasonable compensation (or of excess compensation) that may be appropriate for particular family law purposes. Absent an assignment-specific legal definition, reasonable compensation is generally considered to be the amount that a comparable employee would be paid for comparable services at a comparable company. While this general definition makes intuitive sense, it may be difficult to implement in practice. That is because it may be difficult for the analyst (or family law counsel) to find the so-called comparable employees, services, and companies.

Even assuming that compensation data for comparable companies are available, employees with the same titles at different companies could have different responsibilities. Employees with the same responsibilities may have different titles at different companies. Seemingly comparable companies could have different internal organization structures. The size of the comparable companies could affect compensation levels. Also, the most appropriate comparable companies may not be in the same industry as the subject company.

There is a profession of compensation consultants who design compensation plans and systems for both public and private corporations. When assessing the reasonableness of compensation, these consultants often rely on so-called compensation surveys and databases of (primarily public company) employee compensation data. The use of compensation surveys and salary databases is a generally accepted procedure in reasonableness of compensation disputes for all purposes. These survey- and database-related analyses all, however, have to contend with identifying sufficiently comparable employees who are performing sufficiently comparable services at sufficiently comparable companies.

An alternative method for assessing the reasonableness of shareholder/employee compensation is the independent investor test. As discussed below, the independent investor test was developed in—and is commonly relied on in, federal income tax litigation. However, analysts also generally apply this method for assessing the reasonableness of shareholder/employee compensation in family law disputes—as well as in shareholder, breach of contract, ERISA, and other types of disputes.

In summary, the independent investor test is based on the question: what rate of return on equity (ROE) would an independent (nonemployee) investor find acceptable to induce an equity investment in the closely held corporation? If the close corporation earnings (after the payment of all shareholder/employee compensation) achieve that level of ROE, then the independent investor would be satisfied—and the independent investor would not object to the questionable level of shareholder/employee compensation. If the closely held corporation, however, was not earning its required ROE, then the amount of shareholder/employee compensation would have to be reduced—until the level of company profitability allowed the independent investor to earn a satisfactory rate of return on his or her equity investment.

Analysts are uniquely qualified to perform the independent investor test analysis. The independent investor test analysis procedures include measuring the ROE of the subject corporation. Analysts have experience and expertise in normalizing close corporation financial statements and in quantifying return on investment metrics. Analysts have experience and expertise in identifying objective comparability criteria, from an investment risk and expected return perspective. Analysts have experience and expertise with applying those objective criteria and then selecting (and justifying) comparable companies. Analysts have experience and expertise in normalizing the financial statements of the selected comparable companies. Also, analysts have experience and expertise in quantifying a required rate of ROE from the selected comparable company data. Accordingly, analysts are appropriately qualified to perform the independent investor test to determine the reasonableness of closely held corporation shareholder/employee compensation.

As mentioned above, the independent investor test is a reasonableness of compensation analysis developed within the federal income tax controversy context. Accordingly, much of the professional guidance related to the independent investor test comes from federal income tax judicial precedent. This article focuses on the professional guidance that can be extracted from two U.S. Tax Court decisions. Both Tax Court decisions involved the application of the independent investor test within the context of a reasonableness of close corporation shareholder/employee compensation issue.

INCOME TAX DISPUTES REGARDING SHAREHOLDER/EMPLOYEE COMPENSATION

The Service often challenges the reasonableness of the total amount of compensation that is paid to the shareholder/employees of closely held C corporations. The Service often claims that any alleged excess compensation amounts (particularly amounts paid during the corporation's profitable years) are not tax deductible compensation payments at all. Rather, the Service may claim that such payments are disguised—and nondeductible—dividend payments. The Service typically measures excess compensation as the amount that the corporation pays to the shareholder/employer in excess of what comparable employees would be paid to perform comparable work at comparable companies.

The U.S. Tax Court decision in *H.W. Johnson, Inc. v. Commissioner of Internal Revenue*, docket number 3110-07, filed May 11, 2016 ("the *H.W. Johnson, Inc.*, decision"), provides recent guidance as to how the courts analyze this reasonableness of shareholder/employee compensation issue—particularly for closely held corporations. Although the *H.W. Johnson, Inc.*, decision is only a Tax Court memorandum decision, it is 32 pages in length. Accordingly, this judicial decision provides a fair amount of professional guidance (to both the family law counsel and valuation analysts) regarding the court's rationale in this case.

The *H.W. Johnson, Inc.*, decision is very taxpayer friendly. As discussed below, the decision was influenced by the expert testimony of competing analysts. Also, the forensic analyses of both litigant's analysts—and the court's judicial decision—are heavily influenced by the specific facts and circumstances of the particular closely held corporation.

In particular, the Tax Court was heavily influenced by the application of the independent investor test to assess the reasonableness of the H.W. Johnson, Inc., shareholder/employee compensation. The independent investor text measures whether the corporation earns a fair rate of ROE after allowing for the expense of the shareholder/employee compensation. The fair rate of ROE is based on the ROE that an independent investor would require for an investment in the company.

Valuation analysts are particularly skilled at measuring close corporation ROE. In addition, valuation analysts are particularly skilled at measuring a benchmark (or required level) ROE metric.

The appropriateness of the selected benchmark ROE measure is often based on the degree of comparability of the subject corporation to the selected benchmark data sources.

THE TAX ISSUES IN DISPUTE IN *H.W. JOHNSON, INC.*

H.W. Johnson, Inc. (a C corporation), was the taxpayer in this controversy and the petitioner in this U.S. Tax Court case. The Service determined deficiencies in the taxpayer's federal income tax for the taxable years ended June 30, 2003 and 2004 ("the years at issue"), of $877,440 and $2,087,678, respectively.

The particular income tax issues that the Tax Court had to decide were (1) whether the amounts paid to shareholder/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 (2) whether the taxpayer was entitled to deduct a $500,000 payment made in 2004 to DBJ Enterprises, LLC, an entity controlled by Bruce and Donald, as an ordinary and necessary business expense under Section 162.

Background on *H.W. Johnson, Inc.*

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

The subject 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 founding, H.W. managed all of the company operations, and Margaret 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 they took over daily operations of the company in 1993.

Exhibit 1 H.W. Johnson, Inc. Results of Operations Years 2002 through 2004

Financial Fundamentals	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

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

The 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 company revenue increased materially 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. For the period 2002 through 2004, the H.W. Johnson, Inc., assets, liabilities, equity, revenue, net income before taxes, and net income after taxes are presented in *Exhibit 1*.

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

The Tax Years in Dispute: 2003 and 2004

During the years in dispute, Margaret served as the company president and chairman of the board. Margaret managed the company payroll and finances, accounts receivable and delinquent account collections, employee hiring and terminations, and various other administrative functions, working around 40 hours a 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 of the division operations, including the following functions: contract bidding and negotiation, project scheduling and management, equipment purchase and modification, personnel management, and customer relations.

Bruce and Donald each supervised over 100 employees in their respective divisions, including superintendents and foremen. The two brothers each worked 10 to 12 hours a day, 5 to 6 days a week. The two brothers were at the jobsites daily, and they regularly operated equipment while there. The two brothers were readily available if problems occurred at a jobsite. And, Bruce and Donald were known in the local construction industry for their responsive and hands-on management style.

During the years in dispute, approximately 95 percent of H.W. Johnson, Inc., business was related to residential subdivision construction. The concrete work supervised by Bruce and Donald required both 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 operating equipment was often modified or specially fabricated to meet the requirements of a given job. Most of that equipment modification 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 equality product. As a result, the subject corporation was routinely awarded contracts even where it was not the lowest bidder. H.W. Johnson, Inc., needed little marketing beyond its reputation in the local construction market.

D.B.J. ENTERPRISES, LLC

A reliable supply of concrete was necessary to the company operations. 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 company's supply of concrete, Bruce and Donald suggested to Margaret that H.W. Johnson, Inc., invested 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 D.B.J. Enterprises, LLC (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 (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.

The alleged excess compensation has alimony and support implications.

There were occasional market shortages of cement—an essential ingredient of concrete—during the years in dispute. Arizona Materials, however, 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 its concrete from Arizona Materials during 2004. Also, H.W. Johnson, Inc., was able to procure its 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 that were willing to pay a higher price for its concrete.

THE SHAREHOLDER/EMPLOYEE COMPENSATION ISSUE

At the end of 2004, H.W. Johnson, Inc., made a $500,000 payment to related party DBJ. 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."

The Service noted that H.W. Johnson, Inc., and DBJ had no written agreement regarding the $500,000 payment.

It may be difficult to find comparables.

During the years in dispute, the H.W. Johnson, Inc., board held annual meetings in May to determine officer compensation, director fees, and dividends. For those years, the subject corporation compensated Bruce and Donald as presented in *Exhibit 2*.

The H.W. Johnson, Inc., officer bonus formula was adopted by the company board in 1991, and it was later amended in 1999. The total potential bonuses were calculated in proportion to the company's annual contract revenue, and the amounts were added to a "bonus pool." At year end 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 company bonus pool for later payment, pending the board approval.

Exhibit 2 H.W. Johnson, Inc. Shareholder/Employee Total Compensation For the Years 2003 and 2004

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

During the years in dispute, H.W. Johnson, Inc., had a dividend plan, adopted in 1991, and later 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 income tax deductions for the salaries, bonuses, and director fees paid to Margaret, Bruce, and Donald. The corporation also claimed a deduction for 2004 for the $500,000 amount that it paid to DBJ, reporting the payment as an "administration fees" expense.

The test was developed in tax litigation.

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

THE TAX COURT ANALYSIS

At trial, the Service concluded that deductions of $3,214,000 and $6,532,000 for shareholder/employee compensation were reasonable, leaving $811,039 and $768,916 as the 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. Though 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 compensation amount is reasonable. *See* the *Elliotts, Inc. v. Commissioner* decision, 716 F.2d 1241, 1244 (9th Cir. 1983), *rev'g* T.C. Memo. 1980-282.

In the *H.W. Johnson, Inc.*, case, the taxpayer had the burden of proving that the amounts paid to shareholder/employees Bruce and Donald in 2003 and 2004 were reasonable.

Five Factors Applied to Reasonableness of Compensation

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 the *Elliotts v. Commissioner* decision, 716 F.2d at 1245–1247.

In analyzing the fourth factor, the Court of Appeals emphasized evaluating the reasonableness of shareholder/employee compensation payments from the perspective of a hypothetical independent investor. That is, this fourth factor focuses on whether the independent investor would receive a reasonable return on equity after payment of the shareholder/employee compensation. The independent investor test is described both in the *Elliotts* decision and in the *Metro Leasing Dev. Corp. v. Commissioner* decision, 376 F.3d 1015, 1019 (9th Cir. 2004), *aff'g* T.C. Memo. 2001-119.

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

The Service effectively conceded four of the five *Elliotts* factors that tended to support, or were at least neutral with respect to, the reasonableness of the shareholder/employee compensation paid by H.W. Johnson, Inc. Nonetheless, the Service argued that the subject case hinged on the fourth *Elliotts* factor: that is, whether a hypothetical independent investor would receive an adequate ROE after accounting for the amount of shareholder/employee compensation paid to Bruce and Donald.

Accordingly, the Tax Court considered each of the *Elliotts* factors. The Tax Court, however, focused on the independent investor test.

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 rate of ROE. If the subject corporation ROE (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 company profit-related dividends are not being disguised as salary.

In the subject case, both analyst experts agreed that H.W. Johnson, Inc., earned a pretax ROE of 10.2 percent and 9 percent for 2003 and 2004, respectively. The experts differed, however, on what a required rate of ROE should be for the closely held corporation.

The test includes measuring the ROE.

The Service's analyst used ROE data from four financial report empirical data sources. These four sources indicated an ROE ranging from 13.8 percent to 18.3 percent. The Tax Court concluded that the industry data on which the Service analyst relied were not as reliable as the industry data used by the company's analyst.

The Service analyst's first ROE indication was derived from seven selected "guideline companies." The Tax Court concluded that the selected guideline companies were not sufficiently comparable to H.W. Johnson, Inc. This was because "they were publicly traded, operated in industries different from petitioner's, and had gross sales substantially larger than petitioner's."

The Service 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) the data are not randomly selected and (2) the data may include small sample sizes for certain industries.

The Service 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 Service 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 SIC 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."

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 less than the Integra companies' average ROE in 2003 and 1.9 percentage points less than the Integra companies' average ROE in 2004.

Of course, the parties disagreed about whether H.W. Johnson, Inc., had, in fact, "passed" the independent investor test—even based on the company analyst's ROE conclusions. At trial, the Service argued that, because the subject corporation 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 a ROE that was more commensurate with the company's superior performance, the Service 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 Service produced no authority for its position that the required rate of ROE for purposes of the independent investor test must significantly exceed the industry average ROE, particularly when the closely held corporation 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."

In summary, the *Elliotts* factors—particularly the independent investor test—supported the conclusion that the compensation the close corporation paid to Bruce and Donald in 2003 and 2004 was reasonable. The two brothers were integral to the company's successful financial 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)."

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 DBJ and reported on its 2004 income 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 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 Service argued that the $500,000 payment was not an ordinary and necessary business expense and (1) there was no written agreement or evidence of any oral agreement obligating the company to compensate DBJ, and, therefore, the $500,000 payment was voluntary; (2) DBJ performed no compensable services on behalf of the company; and (3) 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."

The Tax Court noted that Bruce and Donald, acting through DBJ, used the DBJ controlling ownership 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 H.W. Johnson, Inc., 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 two 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 the Arizona Materials formation and operation 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."

And, 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 states: "In the same vein, we do not agree with respondent that DBJ provided no compensable services to petitioner."

In summary with regard to the related party payment, 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."

The Tax Court ruled that the $500,000 payment was an ordinary and necessary expense within the meaning of Section 162(a). This was because it was normal for a concrete contractor to expend funds in connection with ensuring 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.

SUMMARY OF THIS DECISION

The *H.W. Johnson, Inc.*, decision is a taxpayer-friendly judicial decision with regard to the reasonableness of closely held corporation shareholder/employee compensation. Of course, the specific facts and circumstances of the case were very favorable to the subject corporation's position.

First, the Tax Court relied on the *Elliott's* five factors in its reasonableness of shareholder/employee compensation analysis. In particular, the Tax Court relied heavily on the independent investor test to assess the reasonableness of the close corporation shareholder/employee compensation. The independent investor test is based on the reasonableness of the subject corporation's rate of ROE.

Second, both the Service's analyst and the company's analyst applied the independent investor test. The Tax Court seemed to be most influenced by the comparability of (or the lack of comparability of) the benchmark industry empirical data used by both analysts to calculate to required rate of ROE measurement.

Third, the Tax Court concluded that the company did not have to exactly achieve the industry average rate of ROE. For a financially successful company (like H.W. Johnson, Inc.), achieving a ROE sufficiently close to the industry average ROE calculation 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 specific facts and circumstances of the case convinced the Tax Court of the tax deductibility of the DBJ payment.

For closely held corporations, the documentation of the actual facts and circumstances help the company win the day with regard to the tax deductibility of (1) shareholder/employee compensation and (2) related party payments. The Service continues to challenge what it perceives to be unreasonable shareholder/employee compensation or unsupportable-related party payments.

A close corporation (and the valuation analyst) can prevail in a judicial tax challenge based on having the superior factual documentation and the superior empirical analysis. Particularly with regard to the implementation of the independent investor test, valuation analysts are uniquely qualified (1) to measure the subject corporation rate of ROE and (2) to calculate an empirically based benchmark level of an independent investor required rate of ROE.

The Independent Investor Test for Reasonableness of Shareholder/Employee Compensation in Family Law Disputes: Part II of II

BY ROBERT F. REILLY, CPA

Part I of this article covered reasonable compensation and the first income tax case.

Part II of this article will discuss the second income tax case.

THE TAX ISSUES IN DISPUTE IN *BRINKS GILSON & LIONE*

This case involves the U.S. Tax Court decision in the matter of *Brinks Gilson & Lione v. Commissioner of Internal Revenue*, T.C. Memo. 2016-20, docket no. 14413-13, filed February 10, 2016. This matter involves the imposition of the accuracy-related tax penalty. Brinks Gilson & Lione (BGL), an intellectual property law firm, was the C corporation taxpayer in this matter and the petitioner in the Tax Court case. The imposition of the accuracy-related penalty related to the company's mischaracterization of nondeductible dividends paid to its shareholder/attorneys as tax deductible compensation expense. The shareholder/attorney distributions were made in the form of year-end bonus payments.

Section 6662 imposes an accuracy-related penalty if any part of an underpayment of the tax required to be shown on a tax return is due to, among other things, (1) negligence or disregard of rules or regulations or (2) a substantial understatement of tax. The term "understatement" is defined in Section 6662(d)(2)(A) as the excess of (1) the tax required to be shown on the tax return over (2) the amount actually shown on the tax return as filed. In the case of a corporation, an understatement is "substantial" if, as was relevant in the *Brinks Gilson & Lione* case, it exceeds the lesser of (1) 10 percent of the tax required to be shown on the tax return for the subject tax year or (2) $10 million.

In the *Brinks Gilson & Lione* case, the company argued that the Service erred in the imposition of the Section 6662 accuracy-related penalty. The company argued that it had substantial authority for its treatment of the year-end bonus payments as deductible compensation expense. In addition, the company argued that (1) it had "reasonable cause" for the underpayment of the corporation's income tax and (2) it had acted "in good faith." Therefore, the company claimed that it qualified for exceptions to the Section 6662 accuracy-related penalty.

The Tax Court disagreed with all of the company's arguments and imposed the Section 6662 penalty. The Tax Court did not have to determine the reasonableness of the amount of compensation paid to the BGL shareholder/attorneys. The subject company and the Service agreed before the trial that certain amounts of the year-end bonuses were, in fact, excess compensation (and nondeductible dividend payments) for the tax years in dispute.

However, in deciding on the application of the Section 6662 penalty, the Tax Court did consider

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the application of the independent investor test to assess the reasonableness of close corporation shareholder/employee compensation. Based (in part) on its consideration of the independent investor test, the Tax Court concluded that the subject corporation did not qualify for an exception to the Section 6662 accuracy-related penalty. Accordingly, this judicial decision illustrates yet another application of the independent investor test in the judicial determination of the reasonableness of close corporation shareholder/employee compensation.

The *Brinks Gilson Lione* decision is also a Tax Court memorandum decision. Nonetheless, the decision is 38 pages in length. That is, the decision does provide ample judicial guidance to both family law counsel and valuation analysts with regard to the application of the accuracy-related tax penalty, the determination of the reasonableness of close corporation shareholder/employee compensation, and, in particular, the application of the independent investor test.

Description of the Subject Company

The taxpayer in this case is an intellectual property law firm organized as a regular C corporation. For the 2007 and 2008 tax years in dispute, BGL computed its federal taxable income on the basis of a calendar year, using the cash method of accounting. For the years in dispute, BGL also prepared its GAAP accounting financial statements using the cash method of accounting. During the 2007 to 2008 period, BGL employed about 150 attorneys, of whom about 65 were shareholders. BGL also employed a nonattorney staff of about 270. The BGL business and affairs were managed by the firm's board of directors.

The BGL Shareholders

The BGL shareholders owned their shares in the corporation in connection with their employment with the firm as attorneys. Each shareholder/attorney acquired his or her shares at a price equal to the share's accounting book value. Upon a shareholder's employment termination, the shareholder was required to sell the shares back to BGL at a price determined under the same formula. Subject to minor exceptions related to the firm "name partners," each shareholder's proportionate ownership of the BGL shares (*i.e.*, the share-ownership percentage) equaled his/her proportionate share of the total compensation paid by the firm to its shareholder/attorneys. For the 2007/2008 period, the BGL board set the annual compensation paid to the shareholder/attorneys. Then, the BGL board determined the necessary adjustments in each shareholder's share-ownership percentage necessary to reflect the proportionate compensation.

The shareholder/attorneys were entitled to receive dividends as and when declared by the firm's board. It, however, is noteworthy that the company had not declared any dividends for at least a decade before the tax years in dispute.

The BGL Compensation Mechanics

For the tax years in dispute, the BGL board met to set compensation and shareholder-ownership percentages in late November or early December for the following year. Based on the BGL annual budget, the board set each shareholder's expected compensation using a number of criteria including hours billed, collections, business generated, and other contributions to the firm. Because the board's compensation amounts were based on an annual budget, each shareholder only received a percentage of the expected total compensation (referred to as the draw). The remainder of the total compensation was received at year-end (referred to as the year-end bonus). It was the announced intention of the BGL board to distribute the amount of fiscal year-end bonus (referred to as the bonus pool) that would result in the firm reporting a zero GAAP-basis net income for the year.

With very few exceptions for less active attorneys, the BGL shareholders shared in the bonus pool in proportion to their share ownership percentages. For each tax year in dispute, BGL calculated the year-end bonus pool—that is, $8,986,608 in 2007 and $13,736,331 in 2008—to be exactly equal to the firm's (pre-bonus) GAAP-basis net income. Accordingly, the BGL reported (post-bonus) GAAP net income of zero for each year. That is, the BGL financial accounting reported that the firm revenue exactly equaled the firm expenses for 2007 and 2008.

For income tax purposes, BGL reported as employee compensation expense the total amount that it paid to its shareholder/attorneys, including the year-end bonus payments. It is noteworthy that BGL withheld applicable income and employment axes, paid the employer's share of employment taxes, and filed the appropriate employer tax forms, including Forms W-2, Wage and Tax Statement, and Forms 941, Employer's Quarterly

Federal Tax Return. An independent payroll processing firm prepared the BGL Forms W-2 for 2007 and 2008 using records and information that BGL management reported to it. BGL management then provided the Forms W-2 to the firm's public accounting firm, McGladrey & Pullen (now called "RSM").

The BGL Invested Capital Balances

BGL reported shareholders' invested capital, measured by the accounting book value of its shareholders' equity, of approximately $8 million at the 2007 year-end and approximately $9.2 million at the 2008 year-end. The BGL balance sheets for the years in dispute did not report any goodwill or other intangible asset values. This is only noteworthy because the Tax Court noted that the company balance sheets may have understated the economic value of the shareholders' equity.

The BGL Reported Taxable Income

RSM prepared the BGL corporation income tax returns for the tax years in dispute. BGL timely filed its tax returns for 2007 and 2008. In each tax return, BGL included the year-end bonuses it paid to its shareholders as a deduction for officer compensation. Before filing its federal income tax returns, BGL management did not ask RSM whether the full amount of the year-end bonuses paid to the firm shareholders was deductible as compensation expense. Also, RSM did not opine to BGL management on the tax deductibility of the year-end bonuses.

The BGL 2007 tax return reported total income of $91,742,819, taxable income of $539,902, and a tax liability amount of $188,966. The BGL 2008 tax return reported total income of $107,019,812, taxable income of $561,075, and a tax liability amount of $196,376. The GAAP basis net income that BGL reported for each year was zero. Accordingly, the taxable income that BGL reported on is federal income tax return was entirely due to book income versus tax income differences.

The Audit and the Tax Deficiency

During the audit of the 2007 and 2008 tax years, the Service disallowed various deductions, including the year-end bonuses that BGL had paid to its shareholder/attorneys. After a negotiation, the Service and the taxpayer entered into a closing agreement that provided, among other things that portions of the BGL officer compensation deductions for the years in dispute—$1,627,000 in 2007 and $1,859,000 in 2008—"should be disallowed and re-characterized as non-deductible dividends." As a result of certain concessions that BGL made in settlement, the corporation's agreed upon income tax liability was $1,298,618 for 2007 and $1,212,152 for 2008. These tax liability amounts resulted in underpayments of $110,952 and $1,015,776 for the tax years 2007 and 2008, respectively.

The Issues before the Tax Court

Because the audit closing agreement provided that a portion of the BGL officer compensation deductions for the years in dispute "should be disallowed and re-characterized as non-deductible dividends," the deductibility of the shareholder year-end bonuses was not an issue at the trial. The sole issue before the Tax Court was whether the corporation was liable for accuracy-related penalties under Section 6662. The Service's proposed Section 6662 penalty related to the underpayment of tax regarding the BGL deduction of those portions of the year-end bonuses that the corporation agreed was nondeductible dividends.

Section 6662(a) and (b)(1) provides for an accuracy-related penalty of 20 percent of the portion of an underpayment of tax attributable to (1) negligence or (2) the disregard of rules and regulations. Section 6662(a) and (b)(2) provides for the same penalty on the portion of an underpayment of tax attributable to "[a]ny substantial understatement of income tax." Section 6662(d)(2)(A) defines the term "understatement" as the excess of the tax required to be shown on the tax return over the amount actually shown on the tax return as filed. In the case of a corporation, according to Section 6662(d)(1)(B), an understatement is considered to be "substantial" if it exceeds the lesser of (1) 10 percent of the tax required to be shown on the tax return for the tax year or (2) $10 million.

According to Section 6662(d)(2)(B)(i), an "understatement" is reduced by the amount attributable to the treatment of an item for which the taxpayer has "substantial authority." In addition, Section 6664(c)(1) provides an exception to the imposition of the Section 6662(a) accuracy-related penalty if the taxpayer can demonstrate that (1) there was reasonable cause for the underpayment and (2) the taxpayer acted in good faith.

In the *Brinks Gilson & Lione* matter, the taxpayer corporation did not dispute that the deficiency to which BGL had agreed for each of the years in dispute exceeded 10 percent of the income tax it was required to show on its tax return for that year. Rather, the corporation claimed that it had substantial authority for deducting the full amount of the year-end bonuses it had paid to its shareholder/attorneys. In particular, the BGL argued that, because it had relied on the services of a prominent accounting firm to prepare its tax returns, the corporation (1) had reasonable cause to deduct those amounts and (2) acted in good faith in doing so.

If the Tax Court found that BGL in fact had "substantial authority" for its position, then the disallowance of apportion of its claimed compensation deduction would not increase the "understatement" within the meaning of Section 6662(d)(2)(A). If the Tax Court reached that conclusion, then the substantial understatement penalty would not apply to the portion of the underpayment attributable to the disallowance of those deductions, regardless of whether or not BGL had reasonable cause or acted in good faith. In addition, the judicial determination that BGL had substantial authority for its position would also prevent imposition of the negligence penalty.

Accordingly, the Tax Court's first judicial consideration was whether BGL had substantial authority for its deduction of the year-end shareholder/attorney bonuses.

Consideration of Substantial Authority

According to the Tax Court decision: "The determination of substantial authority requires a weighing of the authorities that support the taxpayer's treatment of an item against the contrary authorities. A taxpayer can have substantial authority for a position that is unlikely to prevail, as long as the weight of the authorities in support of the taxpayer's position is substantial in relation to the weight of any contrary authorities."

The Taxpayer's Position

At trial, BGL relied on the decision *Law Offices—Richard Ashare, P.C. v. Commissioner* (see T.C. Memo. 1999-282, 1999 WL 639866) as its principal authority to support the deduction of year-end bonuses paid to the BGL shareholder/attorneys in 2007 and 2008. In the *Ashare* decision, the Tax Court allowed a corporate law firm to deduct the amount that it paid to its sole shareholder as compensation—even though that compensation amount exceeded the firm's revenue for the year.

Also at trial, BGL claimed that Section 83 and the accompanying regulations (that deal with the transfer of property in connection with services) support the proposition that all of the amounts the company paid to its shareholder/attorneys should be treated as deductible compensation expense.

In addition, BGL cited authorities in other areas of the law to support the position that capital is not a material income-producing factor in a professional services business. (See *Hubbard-Ragsdale CO. v. Dean*, 15 F.2d 410 (S.D. Ohio 1926), *Aff'd per curiam*, 15 F.2d 1013 (6th Cir. 1926); Regulation 1.704-1(e)(1)(iv); Regulation 1.911-3(b)(3); Regulation 1.1348-3(a)(3)(ii); and Regulation 1.1361-2(e)2)).

The Tax Court disagreed with all of the company's arguments.

As a final position, BGL argued that, under the so-called substance-over-form principle, the stock held by the BGL shareholders should be treated as debt. Based on this argument, the portion of the year-end shareholder/attorney bonuses determined to be nondeductible as compensation should nonetheless be deductible as interest expense.

In *Brinks Gilson & Lione*, the corporation devoted considerable effort to distinguishing the statutory and judicial authorities relied on by the Service. The Service claimed that the amounts paid to the shareholder/employees of a corporation do not qualify as deductible compensation to the extent that the payments are funded by earnings attributable (1) to the services of nonshareholder/employees or (2) to the use of the corporation's intangible assets or other capital. The Service argued that the amounts paid to shareholder/employees attributable to those sources should be treated as nondeductible dividends.

In support of its position at trial, the Service relied primarily on the Tax Court opinion in *Pediatric Surgical Assocs., P.C. v. Commissioner*, T.C. Memo. 2001-81, and the U.S. Court of Appeals (Seventh Circuit) opinion in *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, 680 F.3d 867 (7th Cir. 2012), *aff'g* T.C. Memo. 2001-74.

In the *Pediatric Surgical* decision, the Service determined that compensation payments to shareholder/employees attributable to the services of nonshareholders should be nondeductible dividends. In the *Mulcahy* decision, the Seventh Circuit denied a corporation's deduction for consulting fees paid to entities owned by the taxpayer's founding shareholders That taxpayer sought to justify its deduction for the consulting fees based on the grounds that the payments were, in effect, additional compensation to its shareholders.

The Service emphasized the *Mulcahy* decision because any appeal of the *Brinks Gilson & Lione* decision would be filed with the Seventh Circuit.

At trial, BGL argued that the subject fact set was distinguishable from the *Pediatric Surgical* decision fact set. This is because any "profit" that BGL made from the services of its nonshareholder/attorneys could justifiably be paid to its shareholder/attorneys in consideration for business generation and other nonbillable services. Also at trial, the corporation distinguished the *Mulcahy* decision fact set based on the allegedly unique nature of the BGL shareholder/attorneys' interests. In particular, the corporation argued that, because (1) the BGL shareholder/attorneys received their stock in connection with their employment and (2) the BGL shareholders had to sell their shares back to the corporation at a price equal to the GAAP basis book value, the BGL shares did not represent "real" equity interests. Therefore, the BGL shares did not entitle the corporation shareholders to a return on their invested capital.

Finally at trial, BGL argued that, because the *Mulcahy* decision was published after BGL filed its tax returns for the tax years in dispute, the *Mulcahy* decision should not be taken into account in assessing the relative weight of authorities for and against the company's substantial authority positions.

THE APPLICATION OF THE INDEPENDENT INVESTOR TEST

According to the Tax Court decision in *Brinks Gilson & Lione*, "The principle applied in *Mulcahy* is well established in the law and grounded in basic economics: The owners of an enterprise with significant capital are entitled to a return on their investments." That statement means that when a corporation pays salaries to shareholder/employees in amounts that leave insufficient remaining profits to provide an adequate return on equity (ROE) to shareholders, that inadequate ROE indicates that a portion of the amount paid as salaries is actually a distributions of earnings.

The Tax Court noted that an increasing number of Federal Courts of Appeal, including the Seventh Circuit, have been moving away from the multifactor analysis in assessing the reasonableness of close corporation shareholder/employee compensation. Instead, the Appeals Courts were focusing on the independent investor test. The independent investor test considers the reasonableness of taxpayer company shareholder / employee compensation from the perspective of whether the residual net income provides an ROE that would be acceptable to an independent (nonemployee) investor. The Tax Court specifically noted the following judicial authority: *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 838 (7th Cir. 1999) rev'g *Heitz v. Commissioner*, T.C. Memo. 1998-220; *Rapco, Inc. v. Commissioner*, 85 F.3d 950, 954-955 (2d Cir. 1996) *aff'g* T.C. Memo. 1995-128; *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1245 (9th Cir. 1983), rev'g and remanding T.C. Memo. 1980-282.

Based on the relevance of the independent investor test as applied in the above-cited judicial decisions, the Tax Court noted that the fact that the *Mulcahy* decision itself was not "authority" was of little consequence for purposes of its decision in this matter.

The Tax Court noted that: "The Court of Appeals for the Seventh Circuit and the other courts that have assessed compensation paid to shareholder employees by its effect on the returns available to shareholders' capital refer to the governing inquiry as the "independent investor test." (See *Exacto Spring Corp. v. Commissioner*, 196 F.3d at 838; *Dexsil Corp. v. Commissioner*, 147 F.3d 96, 100-101 (2d Cir. 1998), vacating and remanding T.C. Memo. 1995-135.)

The independent investor test recognizes that shareholder/employees are economically indifferent to whether the total payments they receive from the close corporation are called compensation or dividends. From an income tax perspective, however, only compensation payments are deductible to the taxpayer corporation. In contrast, dividend payments are not deductible to the taxpayer corporation. Therefore, the taxpayer corporation has a bias toward labeling any payments to shareholder/employees as compensation rather than as dividends, without the arm's-length consideration of what a nonemployee investor would accept as a fair rate of ROE. (See *Owensby & Kritikos, Inc. v.*

Commissioner, 819 F.2d 1315, 1322-1323 (5th Cir. 1987), *aff'g* T.C. Memo. 1985-267 and *Elliotts, Inc. v. Commissioner*, 716 F.2d at 1243.)

The Tax Court noted that "the courts consider whether ostensible salary payments to shareholder/employees meet the standards for deductibility by taking the perspective of a hypothetical 'independent investor' who is not also an employee."

Application of the Independent Investor Test to BGL

In the *Brinks Gilson & Lione* decision, it was easy for the Tax Court to decide: "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."

The trial record established that BGL had substantial capital even without considering the valuation of any off-balance-sheet intangible assets. At trial, the BGL expert witness admitted that a law firm's reputation and customer lists could be valuable intangible assets. The Tax Court, however, did not have to measure the value of any of the BGL intangible assets in its application of the independent investor test ROE. Regardless of such off-balance-sheet intangible assets, BGL reported a book value of shareholders' equity of about $8 million at the end of 2007 and about $9.3 million at the end of 2008.

Reliance on professional advice may constitute reasonable care and good faith.

The Tax Court concluded: "Invested capital of this magnitude cannot be disregarded in determining whether ostensible compensation paid to shareholder/employees is really a distribution of earnings." The Tax Court did not believe that an independent investor would accept a zero percent ROE on an $8 or $9 million book value of equity. Such an independent investor would not allow the BGL board to pay out 100 percent of the corporation's book-basis net income as shareholder/employee compensation—and leave no residual income as a return to the nonemployee/shareholder.

Accordingly, the Tax Court concluded: "petitioner's practice of paying out year-end bonuses to its shareholder/attorneys that eliminated its book income fails the independent investor test."

BGL Claimed an Exemption from the Independent Investor Test

At trial, BGL argued that its shareholder/attorneys held their stock in the corporation solely in connection with their employment. That is, the BGL shareholders acquired their stock at a price equal to its cash-basis book value. And, upon terminating their employment, the BGL shareholders had to sell their stock back to the corporation at a price determined under the same formula. The company argued that, as a result of this arrangement, the BGL shareholder/attorneys lacked the normal rights of equity owners.

The Tax Court did not accept this BGL argument. Rather, in its decision, the Tax Court noted: "the use of book value as a proxy for market value for the issuance and redemption of shares in a closely held corporation to avoid the practical difficulties of more precise valuation hardly means that the shareholder/attorneys do not really own the corporation and are not entitled to a return on their invested capital."

The Tax Court concluded that any BGL shareholders who were not also an employee would generally demand such a return on investment.

The Tax Court concluded that the provisions of Section 83 and its associated regulations actually undermined the company's argument that its attorneys were not really equity holders. BGL cited regulations that determined when property is considered to be "transferred" by an employer to an employee. The Tax Court noted that, under those regulations, a transfer did occur if, upon termination of his or her employment, an employee is required to return the property to the employer for a price that "does not approach the fair market value of the property at the time of surrender." (*See* Regulation 1.83-3(a)(3), (5)).

BGL argued that the obligation that its shareholder/attorneys sell back their stock upon employment termination in exchange for book value meant that the stock was never actually "transferred" to the shareholder/employee. Accordingly, BGL argued that all of the amounts it paid to its shareholders—even any amounts actually designated as dividends—should be treated as compensation for services.

Again, the Tax Court rejected this BGL argument: "But petitioner is mistaken in its claim that the book value of one of its shares does not approach its fair market value." The Tax Court noted that Regulation 1.83-5(a) provides that: "If stock in a corporation is subject to a nonlapse restriction which requires the transferee to sell such stock only at a formula price based on book value . . ., the price so determined will ordinarily be regarded as determinative of the fair market value of such property for purposes of Section 83."

The Tax Court concluded that the Regulation 1.83-3(a)(7) examples cited by the taxpayer were readily distinguishable from the actual BGL fact set. The examples in the regulations involved the requirement to resell stock upon termination of employment for amounts that were demonstrably below the stock's fair market value.

Regarding the claim that the BGL attorneys were not really shareholders, the Tax Court concluded: "More generally, petitioner's argument that its shareholder/attorneys have no real equity interests in the corporation that would justify a return on invested capital proves too much. If petitioner's shareholder/attorneys are not its owners, who are? If the shareholder/attorneys do not bear the risk of loss from declines in the value of its assets, who does?"

The Tax Court noted that the use of share book value as a proxy for share fair market value deprived the BGL attorneys of the right to share in any unrealized appreciation upon the sale of their stock. The same attorneys, however, were correspondingly not required to pay for any unrealized appreciation upon the purchase of their stock. The BGL attorney acceptance of these concessions to avoid difficult valuation issues did not compel those attorneys to forgo any current return on their investment based on the taxpayer's profitable use of its assets in conducting its business. The BGL arrangement effectively provided its attorneys with an ROE through amounts designated as compensation.

The Tax Court concluded this issue as follows: "Were this not the case, we do not believe the shareholder/attorneys would be willing to forgo any return on their investments."

The Other Authorities Cited by BGL at Trial

The Tax Court concluded that the other judicial precedent that BGL cited did not refute the principle that shareholders with significant capital are economically entitled to a rate of ROE. BGL cited the decision in *Law Offices—Richard Ashare, P.C. v. Commissioner*, 1999 WL 639866.

However, that case did not demonstrate that an incorporated law firm with significant capital can pay out compensation that eliminates all book-basis net income. Although the Tax Court allowed the *Ashare* taxpayer to deduct compensation that exceeded the firm revenue for the particular tax year at issue (1993), the taxpayer in that case did not consistently pay compensation intended to eliminate its book-basis income. In fact, the Ashare law firm had reported substantial income for 1990, three years before the tax year in dispute.

In contrast to BGL, the Ashare law firm reported minimal equity capital. The sole shareholder Richard Ashare had only invested $1,000 as equity in that taxpayer corporation. Therefore, a fair rate of return on equity capital (*i.e.*, the independent investor test) was not an issue in the *Ashare* decision.

BGL Argued That Its Stock Is Really Debt

The Tax Court disagreed with the BGL argument that the portion of the year-end bonus determined to be nondeductible as compensation should nonetheless be deductible as interest expense. The Tax Court concluded "We have already rejected petitioner's argument that its stock is not real equity. Despite a departing shareholder's obligation to sell his stock back to petitioner at cash book value, shares of petitioner's stock lack the hallmark characteristics of debt."

The Section 6662 Penalty and the Weighing of Authority

Regulation 1. Section 6662-4(d)(3)(ii) required the Tax Court to consider the relative weight of the legal authority presented by BGL and the legal authority presented by the Service. The Tax Court concluded against the company on this issue, as follows:

> *We conclude that the authorities that support petitioner's deduction of the full amount of the year-end bonuses it paid to shareholder/attorneys are not substantial when weighted against the contrary authorities. The independent investor test weights strongly against the claimed deductions. Petitioner's efforts to characterize its situation as unique do not persuade us. If*

> *the hypothetical independent investor had provided the capital demonstrated by the cash book value of petitioner's shares—even leaving aside the possibility of valuable firm-owned intangible assets—the investor would have demanded a return on that capital and would not have tolerated petitioner's consistent practice of paying compensation that zeroed out its income.*

That is, the Tax Court concluded that BGL did not have substantial authority for the deduction of shareholder/employee compensation that completely eliminated its income and left its shareholders with a zero rate of ROE. Because the corporation did not have substantial authority for its treatment of the year-end bonuses it paid, the agreed disallowance of a portion of the deductions BGL claimed for those payments increased a "substantial understatement," within the meaning of Section 6662(d)(1)(B). That is, the accuracy-related penalties would apply to the corporation unless BGL had "reasonable cause" for its treatment of the year-end bonuses and acted in "good faith" in pursuing that treatment.

REASONABLE CAUSE AND GOOD FAITH

At trial, BGL argued that it should not be subject to the imposition of the Section 6662(a) accuracy-related penalty. BGL presented the argument that it had reasonable cause and acted in good faith with regard to its claimed bonus payment deductions. Accordingly, BGL asserted that it qualified for the Section 6664(c)(1) exception to the accuracy-related penalty.

The BGL position was that its reliance on RSM to prepare its tax returns for the years in dispute qualified as "reasonable cause" and demonstrated "good faith."

The Tax Court disagreed with this "reliance on McGladry" argument for two reasons. First, BGL could not demonstrate that RSM, in fact, actually advised the taxpayer corporation regarding the deductibility of the year-end bonuses. Second, the Tax Court concluded that BGL failed to provide RSM with accurate information with regard to the subject year-end bonus payments.

Consistent with Regulation 1.6664-4(b)(1), the Tax Court recognized that "[a] taxpayer's reliance on the professional advice of an attorney or an accountant may constitute reasonable cause and good faith." The company argued that the RSM failure to apprise BGL of any issue concerning the tax deductibility of the year-end bonuses constituted "advice" on which it could reasonably rely. The facts, however, were that, before filing its tax return for each of the years in issue, BGL did not specifically ask RSM whether the full amount of the year-end bonuses it paid to shareholders was deductible as compensation for services. Also, RSM had never commented to BGL regarding the tax deductibility of the year-end bonuses.

The Tax Court noted that the Section 6664 regulations allow flexibility regarding the form of advice to taxpayers. The regulations, however, provide detailed requirements as to the content of advice that can constitute the taxpayer's reasonable cause and good faith.

The Tax Court, however, concluded that the regulations necessarily contemplate that professional advice, in some form, involves an explicit communication to the taxpayer. Silence cannot qualify as professional advice because there is no way to know whether the tax adviser, in failing to raise an issue, considered all of the relevant facts and circumstances, including the taxpayer's subjective motivation. The tax advisers failure to raise an issue could not indicate whether the adviser even considered a certain tax issue, much less engaged in any analysis, or reached a conclusion.

Therefore, the Tax Court concluded that the RSM failure to raise concerns about the tax deductibility of the year-end bonuses did not constitute "advice" within the meaning of Regulation 1.6664-4(c).

In addition, the Tax Court noted that BGL could not have relied in good faith on the RSM preparation of its tax returns for the years in dispute. This was because BGL had provided RSM with inaccurate information. The Tax Court noted that the error that led to the claim of the disallowed tax deduction was, in the first instance, the company's error.

As a general matter, in the fulfillment of professional responsibilities, an accountant signing a tax return is entitled to rely on information furnished to it by the taxpayer corporation. An accountant only has a limited obligation to make inquiries in the case of manifest errors. In this case, BGL provided to RSM Forms W-2 that characterized the amounts paid to its shareholders as employee compensation.

On this issue, the Tax Court concluded: "Therefore, petitioner's reliance on RSM in preparing its returns for the years in issue does not constitute reasonable cause and good faith and does not relieve petitioner of liability for the accuracy-related penalty."

SUMMARY OF THIS DECISION

The Tax Court concluded that BGL failed to show (1) it had reasonable cause for deducting in full the year-end bonuses it paid to its shareholder/attorneys in the years in dispute or (2) it acted in good faith in claiming such tax deductions. Section 6664(c)(1) provided BGL with no defense to the imposition of the Section 6662 accuracy-related penalties. The Tax Court also determined that BGL did not have substantial authority for the tax deductions at issue in the case.

The Tax Court noted that the parties' agreed upon treatment of part of the bonus payments in each year as a nondeductible dividend resulted in a "substantial understatement" within the meaning of Section 6662(d)(1)(A). Therefore, the Tax Court concluded that the accuracy-related penalty applied to the portion of the BGL underpayment attributable to the recharacterization of that part of the bonus payments for each year.

SUMMARY AND CONCLUSION

Issues regarding the reasonableness of close corporation shareholder/employee compensation often arise in the context of family law disputes. In such disputes, the outside spouse often alleges that the inside spouse is paid excessive shareholder/employee compensation. That excessive compensation reduces the close corporation earnings, and the understated earnings reduces the close corporation value. Finally, that value reduction understates the value of the marital assets subject to distribution.

Issues regarding the reasonableness of close corporation shareholder/employee compensation also arise in many other types of controversies, including federal income tax, shareholder, contact, ERISA, and other disputes.

The general definition of reasonable compensation is what a comparable employee would be paid to perform comparable services at a comparable company. While intuitively appealing, this definition is sometimes difficult to implement in practice.

The independent investor test is one method for analyzing the reasonableness of close corporation shareholder/employee compensation. Although it was developed within the context of federal income taxation, the independent investor test is applicable for many types of reasonableness of compensation controversies—including family law disputes.

Valuation analysts are uniquely skilled to perform the independent investor test. Analysts are experienced in the ROE analysis of close corporations. Also, analysts are experienced at selecting and justifying ROE measurement benchmarks to be used for comparative purposes. In short, the quantitative and qualitative procedures of the independent investor test are all part of the typical analyst's skill set.

This discussion summarized the *H.W. Johnson, Inc.*, Tax Court decision and the *Brinks Gilson & Lione* Tax Court decision. These two decisions provide judicial guidance to both family law counsel and to analysts with regard to the application of the independent investor test to assess the reasonableness of close corporation shareholder/employee compensation.