Reasonableness of Executive Compensation Insights

Lessons Learned from Judicial Precedent Regarding the Reasonableness of Executive Compensation

Pamela J. Garland and Ashley L. Reilly

Introduction

An analysis of the reasonableness of executive compensation is appropriate in a number of business circumstances. Many of these circumstances are discussed in the accompanying article, "Issues Related to a Reasonableness of Executive Compensation Analysis."

This article will discuss the analysis of the reasonableness of executive compensation in relation to income taxation controversies. In particular, we will look for professional guidance and other lessons from a review of the judicial precedent of the relevant federal courts. We will review Tax Court and other federal court cases involving income taxation-related questions of reasonableness of executive compensation. We will also look for lessons taken from these judicial decisions—lessons for closely held business owners, for their legal and accounting advisors, and for independent compensation analysts.

> *"The reasonableness of executive compensation is an important issue for the employee/shareholders of a closely held C corporation."*

The reasonableness of executive compensation is an important issue for the employee/shareholders of a closely held C corporation. Internal Revenue Code Section 162 (a) (1) allows a corporation to deduct salaries as a business expense. However, the amount deducted for salaries must constitute "reasonable compensation" for the services actually rendered.

Often, the Internal Revenue Service will allege that highly compensated employee/shareholders are being paid "disguised dividends" in the form of salaries or bonuses. When there is a federal income tax dispute over the reasonableness of executive compensation paid to employee/shareholders, the matter is often litigated before the appropriate federal courts.

The standards for determining (1) what economic value an employee/shareholder has and, therefore, (2) how much is reasonable compensation for the shareholder's employment have evolved over the years due, in good measure, to numerous decisions of the Tax Court and the various circuits of the U.S. Court of Appeals. Various judicial decisions have resulted in lists of factors to consider in the assessment of reasonable compensation.

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In addition, some courts have found it relevant to assess the reasonableness of executive compensation from the perspective of a detached, independent investor.

The goal of each judicial decision is to consider the matter of employee/shareholder compensation from an objective point of view. Of course, the goal of each judicial decision is also to take into account the unique facts and circumstances of each corporate taxpayer situation.

The Lessons of the *Mayson Mfg. Co.* Decision

Valuable professional guidance with regard to determining reasonable executive compensation is provided by the landmark decision *Mayson Mfg. Co.* v. *Commissioner* [178 F.2d 115 (6th Cir. 1949)]. In *Mayson Mfg. Co.*, the Court of Appeals set out nine factors that should be considered in the determination of the reasonableness of employee/shareholder compensation. The nine *Mayson Mfg. Co.* reasonableness of compensation factors are listed below:

1. The employee's qualifications.
2. The nature, extent, and scope of the employee's work.
3. The size and complexity of the business.
4. A comparison of salaries paid with the gross income and the net income.
5. The prevailing general economic conditions.
6. Comparison of salaries with distribution to stockholders.
7. The prevailing rates of compensation for comparable positions in comparable concerns.
8. The salary policy of the taxpayer as to all employees.
9. In the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employees in previous years.

Since *Mayson Mfg. Co.*, the appeals courts have used various derivatives of these nine factors. In *Elliots, Inc.* v. *Commissioner* [716 F.2d 1241 (9th Cir. 1983)], the Court suggested five factors to determine reasonable compensation for an employee/shareholder.

The five *Elliots, Inc.* factors are similar to the ones set forth in *Mayson Mfg. Co.* and are listed below:

1. The employee's role in the company.
2. A comparison of the compensation paid to the employee with the compensation paid to similarly situated employees in similar companies.
3. The character and condition of the company.
4. Whether a conflict of interest exists that might permit the company to disguise dividend payments as deductible compensation.
5. Whether the compensation was paid pursuant to a structured, formal, and consistently applied program.

"The five Elliots, Inc. *factors are a common benchmark for measuring the reasonableness of executive compensation in a closely held or family-owned company."*

The five *Elliots, Inc.* factors are a common benchmark for measuring the reasonableness of executive compensation in a closely held or family-owned corporation. And, the five *Elliots, Inc.* factors can be used in conjunction with the independent investor test as part of an independent analysis of the reasonableness of executive compensation for a particular taxpayer corporation.

The independent investor test is the most recent judicial guidance with regard to determining the reasonableness of employee/shareholder compensation. While evaluating a particular set of corporate compensation facts and circumstances, the perspective of a hypothetical independent investor is taken into account. In the independent investor test, the amount of compensation paid to the corporate management group (or to an individual executive) is considered reasonable if a hypothetical independent investor would be satisfied with the corporation's return on investment.

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For purposes of the independent investor, return on investment is often measured as return on stockholder's equity. And, of course, the return on stockholders' equity calculation is made after the subject executive compensation is deducted as an operating expense.

The application of these reasonableness of compensation tests is interpreted differently throughout the various circuits of the U.S. Courts of Appeals. Each circuit has essentially developed its own set of factors to be used when deciding a reasonableness of employee/shareholder compensation case. Even though the various factors are all fundamentally similar, the courts have assigned different weights to each reasonableness of compensation factor depending on the circuit.

The Lessons of *Eberl's Claim Service, Inc.*

Even though multiple methods of assessing the reasonableness executive compensation exist, courts sometimes determine this issue using only one method. However, in *Eberl's Claim Service, Inc.* [249 F.3d 994 (10th Cir. 2001), *aff'g* T.C. Memo 1999-211 (June 25, 1999)], the multifactor test was used to determine the reasonableness of the compensation paid to the company's president in 1992 and 1993.

The president, Eberl, ran a catastrophic claims adjusting company that he had incorporated in 1988. The Service found that Eberl's compensation was unreasonable (i.e., excessive) for the years 1992 and 1993.

In 1991, Eberl earned a salary of less than $200,000. In the years 1992 and 1993, his salary was $4.3 million and $2 million, respectively.

In 1991, the company earned gross profits of approximately $2.2 million. In the next two years, there was an increase in the company gross profits to $20 million in 1992 and to $9 million in 1993.

The Appeals Court did not agree with the taxpayer's position that Eberl was wholly responsible for the increase in the corporation's gross profit. An increase in catastrophic disasters in those two years created more business for Eberl's Claim Service, Inc. Therefore, the Appeals Court concluded that general economic conditions—and not Eberl—were significantly responsible for an increase in the corporate revenues.

The financial condition of the company—after paying Eberl's compensation—was detrimental to the taxpayer's case. Because of the size of Eberl's salary in 1992 and 1993, the company reported very low net profits. This meant that the company showed almost no increase in retained earnings related to the large revenues it earned in those two years.

Eberl's Claim Service, Inc., had no formal formula for determining executive salary. The percentage of gross receipts used

to compensate Eberl varied from 1991 to 1992 to 1993 (i.e., they were higher in 1992 and 1993).

Eberl claimed that there was a written agreement that specified the percentage of gross receipts that would be used in determining his compensation. However, without any tangible documentation of the alleged agreement, the Appeals Court did not give this assertion much weight.

Not all of the factors considered by the Court were found to be negative to Eberl. There was little question that he was a well-qualified executive and a hard worker. Because of that, the Appeals Court concluded that Eberl deserved a high level of executive compensation.

However, the Appeals Court concluded that Eberl's actual compensation was unreasonable and, therefore, partially nondeductible. A portion of Eberl's compensation was found to be, in fact, a disguised dividend. That amount was added back to taxable income, and it was subject to additional corporate level taxes.

"Instead, the Appeals Court based its decision entirely on the independent investor test."

The Lessons of *Law Offices of Richard Ashare, P.C.*

A multifactor approach was used in the case *Law Offices-Richard Ashare, P.C.* [T.C. Memo 1999-282 (Aug. 24,1999)]. The Service asserted that the $1.75 million salary paid in 1993 to Richard Ashare, the sole shareholder attorney of the firm, was unreasonable (i.e., excessive) compensation.

Upon hearing the case, the Tax Court ruled that compensation paid to Ashare was reasonable. The Court cited Ashare's value to the company as one reason for concluding that his compensation was reasonable.

In fact, the Tax Court found that Ashare was crucial and indispensable to the company. The Court also found that the company was suitably complex as to require Ashare's specialized expertise.

"Of course, (1) the independent investor test and (2) the multifactor analysis can be used in combination."

In this case, an independent investor's perspective was not required for the Tax Court to reach its conclusion. The company's actions were adequately justified using the reasonableness of compensation factors from the *Elliots, Inc.* decision.

The Lessons of *Exacto Spring Corp.*

In contrast to relying completely on multifactor tests, the independent investor test has sometimes been applied exclusively. In *Exacto Spring Corp.* v. *Commissioner* [196 F.3d 833 (7th Cir. (1999)], the Service claimed *Exacto Spring* had overcompensated its president, William Heitz, in 1993 and 1994. The Tax Court agreed with the Service on the basis of a multifactor test.

When the corporate taxpayer appealed the case to the Seventh Circuit, the judge reversed the Tax Court decision. This is because the Appeals Court concluded that the multifactor test was "redundant, incomplete, and unclear."

The Appeals Court gave the following five reasons why the multifactor test should not be used with regard to *Exacto Spring*:

1. The factors are nondirective.
2. The factors do not relate to each other or to the primary purpose of Section 162(a)(1).
3. Judges are not qualified to determine employee salaries.
4. The factors invite the making of arbitrary decisions.
5. Their use makes the Tax Court's reaction to compensation unpredictable.

Instead, the Appeals Court based its decision entirely on the independent investor test. The Seventh Circuit concluded that a high rate of return to corporate shareholders meant a higher salary could be paid to the corporate executives.

In the case of *Exacto Spring*, the taxpayer's expert testified that the expected rate of return on shareholder's equity was 13 percent. In the years in question, Exacto Spring earned a 20 percent rate of return on shareholder's equity, well above what an independent investor would have accepted. Thus, an independent investor would have approved of the level of executive compensation paid to the company president even though it was a large amount.

Of course, (1) the independent investor test and (2) the multifactor analysis can be used in combination. Some courts have opted to view the various factors used in determining the reasonableness of executive compensation through the perspective of an independent investor. This procedure is often called using the independent investor test as a "lens" through which all other reasonableness of executive compensation factors are examined.

The Lessons of *Alpha Medical Inc.*

In *Alpha Medical, Inc.* [172 F.3d 942 (6th Cir. 1999), *rev'g* T.C. Memo 1997-464 (Oct. 14, 1997)], the Service argued that the

$4.4 million paid in 1990 to the Alpha Medical Inc. president and sole shareholder, William Rogers, was unreasonable (i.e., excessive) compensation. Accordingly, the Service concluded that the excessive amount of Rogers' compensation could not be considered a deductible business expense.

The original Tax Court decision held that (1) the $4.4 million was an unreasonable amount of compensation and (2) it could not be allowed in its entirety as a deductible expense. However, the case was appealed to the Sixth Circuit of the U.S. Court of Appeals in 1999. The Appeals Court reversed the Tax Court decision.

> *"The Appeals Court agreed that undercompensation in past years could justify a higher level of executive compensation."*

In the Appeals Court opinion, the factors that favored Rogers included (1) his qualifications, (2) the nature, extent and scope of his work, (3) the size and complexity of the business, and (4) the argument that he had been undercompensated in prior years.

These factors were also examined by the Appeals Court through the "lens" of the independent investor test.

The Appeals Court found that Rogers had no formal training in business management. However, the Court concluded that he had a great deal of practical experience in his field of work.

The Appeals Court also found that the success of Alpha Medical, Inc., was directly attributed (1) to Rogers' abilities as its employee/owner and (2) to his "ambition, creativity, vision, and energy."

The nature, extent, and scope of Rogers' work also suggested to the Appeals Court that the compensation paid to him was a reasonable (i.e. deductible) amount. Rogers had held most of the management positions at Alpha Medical, Inc. And, he had a wide range of responsibilities and activities that included "sales, personnel, operations, finance, planning, and flying the corporate airplane."

> *"This Tax Court memorandum decision presents an additional means of determining reasonable compensation that is entirely separate from both (1) the independent investor test and (2) the multifactor analysis."*

The Alpha Medical, Inc., business was found to be large and complex. In the four years between 1986 and 1990, the company had experienced considerable revenue growth. The Appeals Court agreed that the nature of a home health care business (such as the Alpha Medical, Inc., business) is complex, requiring extensive knowledge and expertise—and particularly Rogers' extensive knowledge and expertise.

The compensation paid to Rogers was a significant percentage of the net income earned by Alpha Medical. The corporate taxpayer argued that this was due to Rogers being compensated for work performed previously, for which he had been undercompensated. The taxpayer alleged that the $4.4 million compensation level did not reflect compensation to Rogers for just one year.

The Appeals Court agreed that undercompensation in past years could justify a higher level of executive compensation. And, the Appeal Court concluded that the $4.4 million compensation level was justified in the case of Alpha Medical, Inc.

For the year in question, the Appeals Court concluded that the Alpha Medical, Inc., actual return on shareholder equity was greater than the rate of return an independent investor would expect. Therefore, the independent investor test also indicated that Rogers' executive compensation was reasonable.

Taking all factors into account, the Appeals Court found that the executive compensation paid to Rogers in 1990 was reasonable. And, the Appeals Court concluded that the executive compensation could be deducted as a business expense per Section 162(a)(1).

The Lessons of *Haffner's Service Stations, Inc.*

In *Haffner's Service Stations, Inc.* [T.C. Memo 2002-38 (Feb. 11, 2002)], the Service challenged the bonuses that were paid to two of Haffner's corporate officers, Emile and Louise, in the years 1990, 1991, and 1992. The Service contended that the bonuses of $625,000, $475,000, and $250,000 paid to both officers in those years were unreasonable (and nondeductible).

As in the *Alpha Medical, Inc.* case, both (1) the employee qualifications and (2) the nature, extent, and scope of the work performed by the two officers were important factors in the Tax Court's decision.

The Tax Court had previously held that the superior qualifications of an employee can justify a high level of executive compensation (see *Home Interiors & Gifts, Inc.* v. *Commissioner,* 73 T.C. 1142 (1980)). Therefore, the abilities and skills of Emile and Louise came under judicial examination.

The Tax Court determined that the profitability of the company was not a direct result of the personal qualifications of either Emile or Louise. Due to the nature of the subject corporation business operation, the Tax Court concluded that neither Emile nor Louise were vital or irreplaceable. And the Tax Court determined that their employee qualifications did not justify their level of bonus compensation.

The Tax Court also analyzed the nature, extent, and scope of the work performed by Emile and Louise. Again, the Court concluded that Emile and Louise did not play an important role in the company.

According to the Tax Court's decision, Emile and Louise's work was not "fundamental, substantial, or all encompassing." Instead, the Tax Court concluded that a third corporate officer was responsible for most of the important work at the company.

Taking all of the previous evidence into consideration, the Tax Court concluded that, through the eyes of an independent investor, the bonuses paid to Emile and Louise would not be justified. Therefore, the bonus payments were unreasonable (and non-deductible) compensation for the services actually rendered by the two corporate officers.

> *"A recurring theme in reasonableness of executive compensation controversy cases is the need for the corporate taxpayer to document its compensation activities."*

The Lessons of *Pediatric Surgical, Inc.*

This Tax Court memorandum decision presents an additional means of determining reasonable compensation that is entirely separate from both (1) the independent investor test and (2) the multifactor analysis. As illustrated in *Pediatric Surgical Associates*, *P.C.* [T.C. Memo 2001-81 (Apr. 2, 2001)], in order to be reasonable, the compensation paid to an employee/shareholder has to come from the direct activities of that employee/shareholder.

Pediatric Surgical, P.C. had six surgeons. Four of the surgeons were corporate shareholders, and two of the surgeons were not corporate shareholders. In the years 1994 and 1995, the Service maintained that the compensation paid to the shareholder surgeons exceeded the reasonable amount due to them for their employee services rendered.

> *". . . it is equally important that the corporate taxpayer consistently follow its own written compensation policy."*

Section 162(a)(1) states that compensation can only be paid (i.e., deducted) for "personal services actually rendered." The Service asserted that a portion of the shareholders' earnings was the result of work performed by the nonshareholder surgeons. Therefore, this unreasonable (or excessive) compensation paid to the shareholder surgeons could not be deducted as compensation expense by the corporation.

The Tax Court did not agree with the taxpayer's position that the corporate contributions of the shareholder surgeons exceeded the contribution indicated solely by their professional services. The taxpayer argued that the shareholder surgeons were responsible for nonbillable administrative work that the nonshareholder surgeons were not responsible for.

Despite this fact, the Tax Court concluded that the deductions claimed in 1994 and 1995 as compensation expense for the services rendered by the shareholder surgeons exceeded a reasonable (i.e., a deducible) amount.

Overall Lessons from the Federal Courts

A recurring theme in these reasonableness of executive compensation controversy cases is the need for the corporate taxpayer to document its compensation activities. Often, the red flag that creates many reasonableness of compensation controversies is the sudden presence of a very large compensation amount that is inconsistent with previous compensation amounts.

Companies that do not have—or that do not follow—a consistent executive compensation policy find it difficult to explain the reasoning behind their apparently erratic levels of executive compensation.

For this reason, a closely held or family-owned corporation should have a written executive compensation policy that is:

1. set up early in a company's existence,
2. followed consistently in all years, and
3. documented in the corporate minutes.

Several cases illustrate the importance of documenting a company's executive compensation agreement.

In the previously mentioned case, *Eberl's Claim Service, Inc.*, the percentage of gross profits paid to the sole shareholder as compensation in 1992 and 1993 was different than in other years. The Appeals Court found this inconsistency to be indicative of the shareholder (1) paying himself corporate profits in the form of compensation instead of (2) paying himself the corporate profits in the form of dividends.

If the taxpayer corporation had (1) established a formal compensation policy and (2) had consistently followed the practice of paying a set percentage of gross profits as executive compensation, the higher salaries paid in 1992 and 1993 may not have been unreasonable. This is because the 1992 and 1993 compensation amounts would have been the same proportion to gross profits as in other years.

The lack of compensation policy documentation was also an aspect of the case *Normandie Metal Fabricators, Inc.* [T.C.

Memo 2000-102 (Mar. 27, 2000)]. The Tax Court found that the amount paid to the company's employee/shareholders as year-end bonuses was not set according to any documented compensation criteria. This fact led the Tax Court to find that the executive compensation paid to the company's employee/shareholders was not for actual services rendered. And, the excess component of the bonuses was determined to be disguised dividends.

At issue in *Rapco, Inc.* v. *Commissioner* [85 F.3d 950 (2nd Cir. 1996)] were the salaries paid to the Rapco president, Richard Polidori, in the years 1988, 1989, and 1990. While examining the case, the Appeals Court found that Rapco did have a written executive compensation policy formula. However, the Appeals Court did not find this evidence persuasive because:

1. the formula was ignored when determining Polidori's actual compensation, and
2. Rapco did not follow any other consistent compensation formula.

"The history of judicial precedent involving reasonableness of executive compensation indicates an evolving interpretation of how to define reasonable compensation."

It is important that a corporate taxpayer have a documented compensation policy when defending against claims of unreasonable executive compensation. However, it is equally important that the corporate taxpayer consistently follow its own written compensation policy.

In addition to a documented compensation plan, another defense of the amount of executive compensation is a comparison of the subject executives with other employees in a similar position in a similar corporation. Section 162 (a) (1) allows for a deduction for reasonable compensation.

If the executive compensation paid in the closely held corporation is consistent with levels of compensation paid to employees of similar companies, then there is empirical evidence that the subject executive compensation is reasonable.

"An independent analysis of executive compensation can be performed (1) to establish an executive compensation policy or (2) to defend current executive compensation practices in response to an audit or other challenge."

In order to avoid a controversy with the Service, closely held and family-owned corporation owners should to stay aware of the executive compensation procedures, including compensation policies, of other companies in the same field. A corporate taxpayer should be able to defend its executive compensation practices, should an audit or other contrarian challenge occur, with documentation regarding the reasons for its compensation procedures.

Summary and Conclusion

The history of judicial precedent involving reasonableness of executive compensation indicates an evolving interpretation of how to define reasonable compensation. Both (1) the multifactor test and (2) the independent investor test are common procedures for assessing the amount of compensation that can be reasonably attributed to services rendered by an employee/shareholder.

Corporate taxpayers will find themselves in a better position to defend their employee/shareholder compensation distribution if they (1) document and (2) consistently follow an executive compensation policy/formula. Corporation taxpayers can also prepare for an audit or other contrarian review by researching and comparing their executive compensation practices/policies with those of other similarly situated companies.

An independent analyst performing a reasonableness of executive compensation analysis for a closely held C corporation should be familiar with the above-mentioned compensation factors. An independent analysis of executive compensation can be performed (1) to establish an executive compensation policy or (2) to defend current executive compensation practices in response to an audit or other challenge.

Willamette Management Associates analysts have considerable experience in performing independent reasonableness of executive compensation studies in a wide variety of industries. Our analysts routinely prepare these independent reasonableness of executive compensation analyses:

1. for corporate employee/shareholders to prepare for/defend against income tax audits;
2. for private company minority (nonemployee) shareholders who may claim shareholder oppression;
3. for public company (class action) shareholders who may claim dissipation of corporate resources; and
4. for governmental and regulatory agencies.

Pamela Garland is a senior associate in our Chicago office. Pam can be reached at (773) 399-4323 or at pjgarland@willamette.com. Ashley Reilly is an intern research assistant in our Chicago office. Ashley can be reached at (773) 399-4324 or at alreilly@willamette.com. www.willamette.com