

**Office of Chief Counsel
Internal Revenue Service**

memorandum

CC:SER:KYT:NAS:TL-N-3565-00
HPLevine, ID# 62-09574

date:

6/28/00

to: Chief, Examination Division, Kentucky-Tennessee District
Attention: Janice Forsyth

from: District Counsel, Kentucky-Tennessee District, Nashville

subject:

Review of reasonable compensation adjustment

DISCLOSURE STATEMENT

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ISSUE:

What hazards of litigation does the Internal Revenue Service have on a reasonable compensation issue where the compensation paid to the two officer-shareholders was approximately equal to the amount of dividends paid and where the majority of the compensation was a bonus based on a formula which tied to production and available to all other officers, whether they were shareholders or not.

CONCLUSION:

The Internal Revenue Service faces substantial hazards of litigation on a reasonable compensation issue where the compensation paid to the two officer-shareholders was approximately equal to the amount of dividends paid and where the majority of the compensation was a bonus based on a formula which tied to production and available to all other officers, whether they were shareholders or not.

FACTS AND DISCUSSION:

██████████ is a Tennessee business which manufactures and distributes ██████████ products ██████████ products. It is a ██████████ corporation. The Chief Executive Officer (CEO) and Chief Operating Officer (COO) are ██████████. The compensation package has been in writing since ██████████. The company, which commenced operations in ██████████ implemented a profit sharing plan in ██████████. The CEO and COO make almost \$ ██████████ each in salary. For the ██████████ period, the total incentive compensation package (bonuses) paid by the taxpayer was \$ ██████████. Approximately \$ ██████████ went to non-officer employees. The remaining \$ ██████████ went to officers. About ██████████ of the officers were non-shareholders. Of the \$ ██████████ paid to the officers, the CEO and COO ██████████ each received about ██████████ (approximately \$ ██████████ each). All officers receive bonuses on the same basis. The ██████████ received a disproportionate amount since the bonuses were based on an amount proportionate to the respective salaries. The bonuses paid to the non-shareholder officers are about ██████████ of their total compensation. For the ██████████ the ratio is reversed and the salaries are about ██████████ of their total compensation.

The profit sharing plan is determined as a percentage over a floor which started at \$ ██████████. The floor was raised over time to \$ ██████████ so that the profits were not artificially inflated but rather were performance based. The company paid sizable dividends in ██████████. The ██████████ each received dividends of approximately \$ ██████████ each. There are also non-employee shareholders who received dividends. After dividends, retained earnings increased by \$ ██████████ from \$ ██████████ to \$ ██████████. Common stock was on the books at \$ ██████████. There is no paid in capital. The company has a low debt to equity ratio due to their lack of debt. They accumulate earnings to fund expansion. Gross receipts increased from \$ ██████████ in ██████████ to \$ ██████████ for ██████████ to \$ ██████████ in ██████████. Taxable income was \$ ██████████ for ██████████. They claim to have ██████████ of the market in sales dollars and ██████████ in the number of ounces.

The founder [REDACTED] The CEO [REDACTED] started with the company in [REDACTED]. He attributes the growth to packaging the product in the [REDACTED] packs. He took over the company in [REDACTED] or so. The COO [REDACTED] attributes the increasing success to assembly line efficiencies that he instituted. The [REDACTED] own the majority of the voting and [REDACTED]-[REDACTED] of the nonvoting stock. Dividends are paid out as a percentage of both voting and nonvoting stock.

Historically, the courts including the Sixth Circuit to which appeal of this case would ultimately lie have used judicially created factors to assist it in making the determination as to whether compensation was reasonable.¹ These factors collectively are intended to allow for an objective examination of all of the relevant facts and circumstances. The courts acknowledge that reasonable compensation issues frequently arise in closely-held businesses where the shareholders are the key employees since it is in the best interests of those parties to characterize the payments as deductible compensation. Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1322-23 (5th Cir. 1987); Alpha Medical, Inc. v. Commissioner, 172 F.3d 942 (6th Cir. 1999).

The Sixth Circuit formulated the factors to be considered in reasonable compensation cases as early as 1949. Mavson Mfg. Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir. 1949). These factors include:

1. The employee's qualifications;
2. The nature, extent and scope of the employee's work;
3. The general economic conditions;
4. A comparison of salaries paid with gross and net income;
5. The prevailing general economic conditions;
6. Comparison of salaries with distributions to shareholders;
7. The prevailing rates of compensation paid for comparable positions in comparable concerns;

¹ Under I.R.C. § 7482(b), venue for an appeal from the lower court such as the Tax Court is generally taken to the judicial circuit where the principal place of the business is located.

8. The amount of compensation paid to the employee in question; and
9. The salary policy of the taxpayer to all employees.

No single factor is decisive. Id. Rather, the totality of the facts and circumstances must be weighed and considered. The court will carefully scrutinize the facts where a corporation is controlled by the employees to whom the compensation is paid in order to ensure that the compensation paid is on account of services performed and not as a distribution of earnings. Id.

While factors 1 and 2 would need to be scrutinized, they do not appear to materially factor into this determination. Rather, we understand that the officer-shareholders perform the ordinary functions of CEO and COO. Therefore, we can presume for purposes of this analysis that they performed those functions and therefore should be compensated.²

From [REDACTED] through the [REDACTED] period, gross receipts increased from \$ [REDACTED] to \$ [REDACTED]. While the reporting period is too long for compensation comparability purposes, it does reflect the steady growth of the business. For purposes of this case, additional data between [REDACTED] when the CEO took over the business until the [REDACTED] would be a narrower gauge of performance valuation. Needless to say, while the additional information may shed light on this, the broad economic indicators indicate that the additional information may not matter. Although the business operates in a competitive market, it claims that it has managed to carve out substantial market shares in terms of dollars and ounces of product sold. It appears to have done this by capturing the below premium or value market. This is reflected in the disparity between the disproportionate amount of market share between dollars ([REDACTED]%) and ounces ([REDACTED]%) as reflected. This suggests that there are either manufacturing efficiencies or that the taxpayer merely priced its product lower to capture market share or elements of both.³

² This factor could marginally be in favor of the taxpayer due to the extensive knowledge of the taxpayer by the officer-shareholders based on their long employment records.

³ According to data provided by the taxpayer, while net sales did not rise as rapidly as its competitors, who were multiples larger, its net income rose at a faster pace which may reflect greater manufacturing efficiencies.

Aside from greater than historical increases in receipts and earnings from the time that the CEO and COO were promoted into these respective positions, this factor should not have much bearing on the reasonableness of the compensation.⁴

For the year at issue, the two shareholder [REDACTED] were paid approximately \$ [REDACTED] in salaries and bonuses. Taxable income was \$ [REDACTED] for that period. Compensation as a percentage of taxable income was therefore [REDACTED]%. It was [REDACTED]% of gross receipts. In contrast, the court approved the compensation paid in Alpha Medical, Inc. which amounted to [REDACTED]% of taxable income and [REDACTED]% of gross receipts. See also Normandie Metal Fabricators, Inc. v. Commissioner, T.C. Memo. 2000-102, where the taxpayer claimed deductions for compensation to the two officer-shareholders equaling [REDACTED]%, [REDACTED]% and [REDACTED]% of net income before taxes and [REDACTED]%, [REDACTED]% and [REDACTED]% of gross receipts for [REDACTED] through [REDACTED], respectively. Even in the Normandie Metal Fabricators, Inc. case, the court approved compensation equaling [REDACTED]%, [REDACTED]% and [REDACTED]% of net income before taxes and [REDACTED]%, [REDACTED]% and [REDACTED]% of gross receipts for [REDACTED] through [REDACTED] respectively. These amounts are well in excess of those claimed in this case.

Another factor that the court examines is the general economic conditions during the taxable years in question. The purpose is to ensure that the financial results are performance based and not due to artificial inflationary conditions. Although we do not know the extent that this factor has been factually developed, the economic conditions in the United States were generally considered to be favorably in balance during the taxable year with sustained growth and low inflation. Moreover, much of the consideration paid to the two officer-shareholders were performance based bonuses. These two aspects reflect that the economic conditions and therefore the financial results were probably not artificially inflated.

⁴ Having said that, to the extent that you believe that this issue should be further pursued, it will be necessary to scrutinize operational policies during this period and business plans that were implemented. For example, to the extent that there were changes in the business operations that were successfully implemented, it can be expected that the court will determine that the officers should be compensated for the above average increase in earnings and/or share value. The converse will hold true. Unsuccessful strategies will be punished. See Normandie Metal Fabricators, Inc. v. Commissioner, T.C. Memo. 2000-102.

The amount of compensation paid to the two officer-shareholders in earlier years is relevant if the taxpayer is attempting to argue that they are being compensated for undercompensation in the past. No information is available at this time on this and we presume for the moment that this is not an issue. If under the facts and circumstances analysis, the extent that the compensation is unreasonable is close, then this could be a decisive factor.

An inadequate dividend history is an indication that compensation is being disguised as a dividend, inviting special scrutiny and supporting an inference that the payments were a distribution of profits. Alpha Medical, Inc. v. Commissioner, 172 F.3d 942 (6th Cir. 1999). Unlike many closely-held corporations, the taxpayer has a consistent and developed dividend history. The company paid sizable dividends in [REDACTED]. The two [REDACTED] each received dividends of approximately \$ [REDACTED] each. There are also non-employee shareholders who received dividends. After dividends, retained earnings increased by \$ [REDACTED] from \$ [REDACTED] to \$ [REDACTED]. Common stock was on the books at \$ [REDACTED]. Assuming arguendo that the two officer-shareholder held a collective [REDACTED]% interest, the taxpayer paid approximately \$ [REDACTED] in dividends in the [REDACTED] period. This approximates [REDACTED]% of taxable income. Importantly, retained earnings increased by \$ [REDACTED] from \$ [REDACTED] to \$ [REDACTED]. The courts have acknowledged that stock appreciation as a return to the investors is an acceptable substitute for dividends. Id. Common stock was on the books at \$ [REDACTED]. The return on equity, including the retained earnings and common stock, would therefore approximate [REDACTED]%.⁵ This factor may prove to be important should the Internal Revenue Service wish to pursue this adjustment.

The court in Alpha Medical, Inc. v. Commissioner, 172 F.3d 942 (6th Cir. 1999) considered return on equity to the shareholders to be an important factor. In that case, the court determined that the total return on equity during the year at issue was [REDACTED]%, a return which the court believed would satisfy an independent investor. This return was of course skewed because of the small size of the taxpayer. In contrast, the return on equity in this case was approximately [REDACTED]%. The extent to which this type of return would satisfy an independent investor ultimately may be dispositive of this issue. To the extent that you pursue this issue, we suggest as a preliminary matter, that you secure the services of an outside expert to review among other things, the type of return sought by an investor in a venture of the size and risk of the taxpayer.

⁵ According to the taxpayer's data, the return on equity was between [REDACTED]% and [REDACTED]% between [REDACTED] and [REDACTED]. Exhibit B.

Even if the return on investment is low for the risk that the investors have to incur, there are other factors that the court may consider to offset this. While the officer-shareholders have control over the corporation through the voting stock, the collective amount of stock that they own which would entitle them to dividends was only about █%. At first blush, this appears to favor the Internal Revenue Service as it gives them incentive to pay the earnings out as compensation. However, a contra-argument is that this supports the amounts paid as compensation since they owe fiduciary duties to the minority. The taxpayer and the court may use this tension among interests (albeit less than there would be if the majority of the shareholders could elect the board of directors), particularly for those non-employee shareholders who rely exclusively upon dividends, to bootstrap themselves into an arm's length determination.

Because of the inherent difficulty in valuation issues, the emphasis of the court is generally in attempting to determine whether profits disguised as salary are being siphoned out of the corporation. The fact that dividends were paid in amounts which equaled their salary reflects that they were not attempting to disguise dividends as deductible salary. Moreover, the fact that their salaries were disproportionately based on a profit-sharing formula which was tied to inflation to ensure performance based measures and which was available to all employees also reflects an attempt to compensate the officer-shareholders for performance and not as a guise for dividends. See Alpha Medical, Inc. v. Commissioner, 172 F.3d 942 (6th Cir. 1999) (contingent compensation formulas which are tied to profits are often adopted to inspire productivity and will be upheld if pursuant to an arm's length agreement even if the compensation was greater than anticipated at the time that the agreement was entered into).⁶

⁶ In this regard, the taxpayer can argue that the increase in the bonus floor for inflation supports its position, since the floor reduces the amount of compensation that will be paid.

We understand that you believe that the compensation was unreasonable primarily because of studies and analyses which reflect that the CEO and COO of a bakery manufacturer earns about \$ [REDACTED] and \$ [REDACTED] respectively instead of the \$ [REDACTED] collectively paid here. Although we agree that this can be an important factor, comparability is proportionate to the weight that will be accorded to the data. The courts acknowledge that this factor may ultimately be the most determinative. Rutter v. Commissioner, 853 F.2d 1267, 1273 (5th Cir. 1988). To the extent that your comparable represents the amounts paid for similar services in similarly sized businesses in like businesses, then we agree that this factor will support the Internal Revenue Service's position and may be sufficient to overcome any adverse factors.⁷

In summary, in determining whether the compensation is reasonable, the courts will focus on and accord greater weight to objective factors such as the return that an independent investor would seek on its investment and what comparable concerns pay in an arm's length transaction for similar services. Although there are factors which favor the taxpayer here, the greater the extent that these two factors favor the Internal Revenue Service, the better the possibility that the adjustment will be sustained. In this regard, you should be able to determine the similarities of the comparables and the return on investment sought by an investor with the level of risk inherent in the business by outside experts. Although you believe that the compensation is inherently unreasonable because the officer-shareholders collectively earn as much as the two top officers for the larger national competitors, we do not believe that this factor alone is dispositive. Rather, once it appears that compensation is unreasonable, there must be some basis to determine a reasonable amount. In this regard, the courts will not substitute their business judgement to that of a successful corporation. To the extent that the taxpayer can establish that their performance and return to investors were greater than their competitors, then the court could conclude that the additional salaries were not unreasonable.⁸

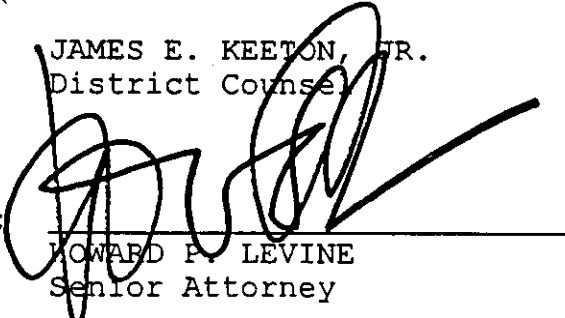
⁷ It is important to quantify as many variables as possible in order for the industry average to be as accurate as possible and allow for a meaningful comparison. Since the comparables are competitors with operations well in excess of those of the taxpayer, you may want to consider whether one of the specialized subsidiaries is more comparable.

⁸ The Internal Revenue Service also faces hazards of litigation because of the relatively smaller degree in which you have determined that the compensation was unreasonable. In this regard, instead of multiples which are traditionally involved in

Please contact the undersigned at (615) 250-5072 if you have any questions. Attached is a client survey which we request that you consider completing. We are requesting post-review from the National Office because of the factual and legal difficulties inherent in reasonable compensation issues.

JAMES E. KEETON, JR.
District Counsel

By:


HOWARD P. LEVINE
Senior Attorney

Attachment:

Client Survey

cc: ARC (LC) Don Williamson
(Via e-mail)

cc: ARC (TL) Roy Allison
(Via e-mail)

cc: Group Manager Jim Hare

these cases (such as \$2.5 million paid and deducted vs. \$500,000.00 determined for a 5X multiple), the spread here is much smaller (\$ [REDACTED] paid vs. \$ [REDACTED] as determined or a multiple of [REDACTED]).