

Office of Chief Counsel  
Internal Revenue Service

## memorandum

CC: [REDACTED]: TL-N-3353-99  
[REDACTED]

date: June 22, 1999

to: Chief, Examination Division, [REDACTED]  
Attn: [REDACTED]

from: District Counsel, [REDACTED]

subject: [REDACTED]  
Unreasonable Compensation Adjustment

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### ISSUE

Should an unreasonable compensation theory be raised as an alternative basis for the proposed adjustment in this case?

### CONCLUSION

No. It is unlikely that an unreasonable compensation adjustment will be sustained on these facts.

FACTS

[REDACTED] and related entities manufacture and market various [REDACTED] which are sold primarily through [REDACTED]. A partnership, [REDACTED] (Partnership), owns all the voting stock in [REDACTED] as well as in [REDACTED] an entity that conducts selling activities at the various retail locations.

[REDACTED] makes commission payments to Partnership for sales activities performed by Partnership. These payments amount to [REDACTED] percent of net sales of [REDACTED]. Partnership then pays a fee of [REDACTED] percent to [REDACTED] to perform the actual marketing services. These functions were transferred in [REDACTED] from Partnership to [REDACTED], in order to shield the partners from liability. After [REDACTED], Partnership is strictly an ownership entity, whose partners are passive recipients of the income stream generated by the [REDACTED] business. One of the things that Partnership retained the ownership of, however, was the right to market [REDACTED] under the [REDACTED] name and associated "marketing intangibles."

The partners in Partnership are [REDACTED] ([REDACTED]%), [REDACTED] ([REDACTED]%), and the [REDACTED] ([REDACTED]%). The beneficiaries of the trust are [REDACTED], [REDACTED], [REDACTED], and [REDACTED]. Partners [REDACTED] and [REDACTED] are also officers of [REDACTED].

Partnership was originally formed in [REDACTED] to operate the [REDACTED] business, which had previously transacted business as the sole proprietorship of [REDACTED]. In [REDACTED] Partnership transferred certain assets valued at \$[REDACTED] to [REDACTED]. The purpose of the transfer was to insulate the partners from liability arising from the manufacture of [REDACTED] products. Concurrent with this transfer, an agreement was entered into between [REDACTED] and Partnership under which the latter retained all sales and marketing rights for the [REDACTED] product line.

In [REDACTED], [REDACTED] contracted with [REDACTED] to act as the Corporation's marketing representative in the [REDACTED] United States. This exclusive agreement was terminated in [REDACTED] and the sales and marketing activities were transferred to Partnership. As mentioned above, the sales activities were transferred to [REDACTED] in [REDACTED], which performs its functions pursuant to a written distribution agreement executed with Partnership.

[REDACTED] makes crucial decisions as to the nature of the [REDACTED] product line (such as product ingredients and package designs, as well as decisions relating to basic advertising and pricing policies). The essential strategy has been to position [REDACTED] products in the [REDACTED] of the [REDACTED] market. [REDACTED] pays most of the direct sales expenses involving advertising and displays, as well as costs associated with trade shows. Compensation to the sales staff employed by [REDACTED] is paid by [REDACTED]. The marketing strategy of the [REDACTED] organization has been successful. The annual growth in sales of [REDACTED] products averaged [REDACTED] percent during the early [REDACTED]'s, which is considerably above the growth rate for the industry as a whole.<sup>1</sup>

The two key players in the marketing arena are [REDACTED] and [REDACTED], both of whom are officers of [REDACTED]. [REDACTED], currently vice-president, is the individual responsible for initiating and maintaining the [REDACTED] retailing connection. The importance of this responsibility, as evidenced by the success of the overall marketing strategy, has been amply reflected in his salary, which averaged \$ [REDACTED] per year during the early [REDACTED]'s.

[REDACTED] is President of [REDACTED]. Over the years, he has been involved in all aspects of the business. He may also be able to claim a portion of the credit for the success of the [REDACTED] marketing strategy. He receives a substantial salary, which averaged \$ [REDACTED] per year during the same period.

[REDACTED], through its sales staff, maintains and augments the retail presence of [REDACTED] products through the [REDACTED] market segment. [REDACTED] is a [REDACTED] in the [REDACTED] market and is positioned as [REDACTED] in its retail locations. Since most consumers require considerable assistance when purchasing the product, store personnel need to be knowledgeable about the products and comfortable in selling the products. [REDACTED] presentation, attractive point of purchase displays, and periodic training of store employees are critical success factors in the [REDACTED].

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<sup>1</sup> Average annual rates of growth of sales for industry peers (SIC = [REDACTED]) for the 5 year period ending in [REDACTED] were as follows: [REDACTED], [REDACTED] percent; [REDACTED], [REDACTED] percent; [REDACTED], [REDACTED] percent; [REDACTED], [REDACTED] percent; [REDACTED], [REDACTED] percent.

Source: [REDACTED] database.

[REDACTED]. [REDACTED] maintains [REDACTED] sales representative for every [REDACTED] stores. The taxpayer believes that in-store sales support and service that the representatives provide is critical in the [REDACTED] market and have enabled the [REDACTED] product line to win the battle for [REDACTED].

Some of the functions of the sales representatives (according to their job description) include the following:

[REDACTED]

**LAW AND ANALYSIS**

I.R.C. § 162(a) provides that

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

- (1) a reasonable allowance for salaries or other compensation for personal services actually rendered.

Treas. Reg. § 1.162-7(a) provides that

There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

Section 1.162-7(b) provides that

The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. . .<sup>2</sup>

The fundamental problem with pursuing an unreasonable compensation argument in this case is that the payments at issue are not "paid in the form of compensation" for services performed by the officers. They are payments to Partnership for a services contract and for use of the [REDACTED] trade name. If Partnership were not the historical entity, which has retained the valuable trade name, then it might be possible to apply the step-transaction doctrine. On these facts, however, that doctrine is clearly not applicable. See, e.g., American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948), aff'd per curiam 177 F.2d 513 (3rd Cir. 1949); cert. denied 399 U.S. 920 (1950). The issue in the case will have to remain the reasonableness of the payments to Partnership as payments to a related entity. We have coordinated our position with the national office, and the national office concurs.

#### CONCLUSION

It is unlikely that an unreasonable compensation argument will succeed on these facts, and we recommend against developing it.

[REDACTED]  
Attorney

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<sup>2</sup> Audit guidelines are set forth in The Internal Revenue Manual, Handbook No. 4233, Tax Audit Guidelines, Partnerships, Estates and Trusts, and Corporations, Sub-SubSection 232.2, Officer's Salaries (Date document last amended: 3-11-1985).