

Reasonable compensation continues to be an issue for closely held C corporations

June 10, 2013

In brief

In a recently decided Tax Court case, *Aries Communications Inc. & Subs. v. Commissioner*, T.C. Memo. 2013-97 (April 10, 2013), the taxpayer, a C corporation, deducted approximately \$6.9 million in compensation paid to its sole shareholder for his role as president, chief financial officer, and general manager of a radio broadcasting business. Upon examination, the IRS disallowed a large portion of the \$6.9 million deduction, arguing that only approximately \$0.8 million of the compensation was ‘reasonable.’ The Tax Court disagreed with both the taxpayer and the IRS, holding that approximately \$2.7 million was deductible as reasonable compensation.

This case is another reminder that closely held corporations cannot avoid double-taxation by paying their shareholder-employees excessive amounts of compensation (see also *Multi-Pak Corp. v. Commissioner*, T.C. Memo. 2010-139 (June 22, 2010)). It also is a good reminder that the IRS is willing to go to court over the issue when the amount of compensation paid to a corporation’s shareholder-employees is not considered reasonable in light of the facts and circumstances. Accordingly, closely held corporations should strive to ensure that their shareholder-employees are receiving compensation that is commensurate with the services being rendered. Corporations and their shareholder-employees also should make sure they understand the factors that may be employed by the IRS and the courts in evaluating the reasonableness of such compensation. A thorough understanding of the relevant factors will help taxpayers proactively evaluate the risks associated with compensation-related planning, potentially resulting in better outcomes upon examination or trial (see *Menard, Inc. v. Commissioner*, 560 F.3d 620 (7th Cir. 2009)).

In detail

Background

Shareholder-employees of closely held corporations generally prefer to receive deductible compensation instead of nondeductible dividends to minimize the effect of double-taxation. As a result, compensation arrangements

between shareholder-employees and their corporations often include meaningful salaries and significant bonuses. Regardless of the specific scenario, a shareholder-employee’s compensation must be commensurate with the services being rendered to be deductible. In other words, the compensation cannot be

excessive – it must be ‘reasonable.’

Why is the reasonable compensation analysis so difficult?

Section 162(a) allows a deduction for “all the ordinary and necessary expenses paid or incurred during the taxable year

in carrying on any trade or business, including . . . a reasonable allowance for salaries or other compensation for personal services actually rendered.” Reg. section 1.162-7(a) adds that “[t]he test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.” The IRS and the courts generally focus on whether compensation is reasonable as opposed to whether compensation is purely for services because if compensation is not reasonable it generally can be assumed that at least a portion of the payments is not for services rendered. Unfortunately, neither Section 162 nor the regulations adopt a bright-line test for determining whether compensation paid to a shareholder-employee of a closely held corporation is reasonable. Instead, the determination is based on an analysis of the taxpayer’s specific facts and circumstances in light of relevant case law. As a result, determining whether compensation paid to a shareholder-employee of a closely held corporation is reasonable can be quite difficult.

How are a taxpayer’s specific facts and circumstances analyzed?

The IRS and the courts generally have taken one of two approaches in determining whether compensation paid to a shareholder-employee of a closely held corporation is reasonable. Both approaches are somewhat subjective and require a degree of judgment. The first is a multi-factor approach, derived mainly from *Mayson Manufacturing, Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949), and *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983). The second is a single-factor approach, based on what is referred to as the ‘independent investor’ test, derived mainly from *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833

(7th Cir. 1999). The specific approach depends on the circuit in which the taxpayer resides, pursuant to the *Golsen* rule.

The Mayson factors

In *Mayson*, the Sixth Circuit identified nine different factors to consider in determining whether compensation is reasonable, with no single factor being determinative.

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 net income of the business
5. The prevailing general economic conditions
6. A comparison of salaries with distributions to stockholders
7. The prevailing rates of compensation for comparable positions
8. The salary policy of the taxpayer as to all employees
9. The amount of compensation paid to the particular employee in previous years

The Elliotts factors

In *Elliotts*, the Ninth Circuit identified five factors to consider in determining whether compensation is reasonable, with no single factor being determinative.

1. The employee’s role in the company
2. An external comparison to other businesses
3. The character and condition of the business

4. Whether there is a conflict of interest regarding the negotiation of compensation
5. Whether there is internal consistency in a company’s treatment of payments to employees

In addition to compressing the nine *Mayson* factors into five factors, *Elliotts* is noteworthy in that it introduced the concept and relevance of an ‘independent investor’ in determining whether compensation is reasonable. In this regard, the Ninth Circuit stated:

“In evaluating the reasonableness of compensation paid to a shareholder-employee, particularly a sole shareholder, it is helpful to consider the matter from the perspective of a hypothetical independent investor. A relevant inquiry is whether an inactive, independent investor would be willing to compensate the employee as he was compensated. The nature and quality of the services should be considered, as well as the effect of those services on the return the investor is seeing on his investment. The corporation’s rate of return on equity would be relevant to the independent investor in assessing the reasonableness of compensation in a small corporation where excessive compensation would noticeably decrease the rate of return.”

The Ninth Circuit considered the perspective of an independent investor in connection with its conflict of interest and internal consistency factors. In essence, the Ninth Circuit took a broad view of the multi-factor approach, considering the perspective of an independent investor as a useful tool in analyzing the various factors. Subsequently, other courts embraced the same view.

*The *Exacto* single factor 'independent investor' test*

In *Exacto*, the Seventh Circuit adopted a stricter and narrower 'independent investor' test for determining whether compensation is reasonable. Under this single factor approach, compensation is presumptively reasonable if investors in the company are obtaining a "far higher return than they had any reason to expect."

In its analysis, the Seventh Circuit noted that instead of rejecting the multi-factor approach, some other courts had taken a broader view of the multi-factor approach, reasoning that the independent investor test is the 'lens' through which the various factors are viewed. However, the Seventh Circuit considered such a stance a 'formality' and stated that "[t]he new test dissolves the old and returns the inquiry to basics."

What's new? – The *Aries Communications* case

In *Aries Communications*, the taxpayer, a C corporation, sold advertising spots on radio stations in connection with its broadcasting business. From 1983 through the tax year ended August 31, 2004 (the year at issue), N. Arthur Astor was the president, chief financial officer, and sole shareholder of the company. He also served as the general manager of each radio station. He was a 'hands-on' manager who actively was involved in many aspects of the company's day-to-day operations, from oversight of personnel to execution of programming to negotiations with lenders. For the tax year ended August 31, 2004, the taxpayer paid Mr. Astor approximately \$6.9 million in compensation, most of which was in the form of a bonus. The taxpayer deducted the entire amount as reasonable compensation, arguing, in part, that the compensation paid to

Mr. Astor included catch-up amounts related to three prior years. Upon examination, the IRS disallowed a large portion of the \$6.9 million deduction, arguing that only approximately \$0.8 million of the compensation was reasonable. In determining how much of the compensation paid to Mr. Astor was reasonable, and therefore deductible, the Tax Court relied on the multi-factor test outlined in *Elliotts*, as supported by the independent investor test.

1) Role in the company

This factor focuses on the employee's importance to the overall success of the business. Pertinent considerations include the employee's position, hours worked, and duties performed.

In *Aries Communications*, the Tax Court made two distinctions as to why this factor weighed in favor of the taxpayer. First, Mr. Astor was a 'key employee,' actively involved in the day-to-day operations of the company as its president and chief financial officer. He also was the general manager of each radio station. Second, Mr. Astor played a 'pivotal' role in the profitable sale of the company's major assets, including significantly appreciated FCC licenses.

2) External comparison

This factor compares the employee's compensation with the compensation paid by similar companies for similar services. While the testimony of expert witnesses may play a role in the comparison, the courts are not bound by the opinion of such experts.

In *Aries Communications*, the Tax Court carefully weighed the divergent opinions of each expert in evaluating the fixed (i.e., salary) and variable (i.e., bonus) components of Mr. Astor's compensation. Both experts compared the compensation of

executive officers at other companies and then used linear regression (i.e., a statistical analysis) to compare the companies' income with that compensation. The difficulty in this approach was that Aries Communications was one of only a few companies in the industry where the owner was also the operator. Furthermore, there were not very many companies whose financial information was publicly available, and those companies whose financial information was available were not similar in size to Aries Communications. Based on these factors, and certain assumptions used in the calculations, the Tax Court determined that both experts explained the variation in compensation 'about as well (or as poorly).'

Because both experts agreed that Mr. Astor was underpaid with respect to his fixed compensation, the Tax Court decided to give equal weight to each expert's conclusion and split the difference to determine the amount of fixed compensation that was reasonable. The result was a relatively small increase in fixed compensation. With respect to Mr. Astor's variable compensation, the Tax Court focused on one of Mr. Astor's bigger accomplishments – increasing the sales price of certain business assets from \$12 million to \$18 million. In this regard, the Tax Court stated:

"Mr. Astor, acting in his executive capacity, was responsible for increasing the sale price from \$12 million to \$18 million, or by 50%. Mr. Astor also had significant involvement in his executive capacity, acquiring, managing, and selling the investment. Given his dual status as shareholder and chief executive officer he would in all events have been motivated to obtain the highest sale price possible. Nevertheless, his efforts as an employee are still entitled to reasonable compensation for services

actually rendered. In short, his executive efforts over a number of years permitted Aries to capitalize on this business opportunity (citations omitted)."

Based on this line of reasoning, and its best judgment, the Tax Court concluded that Mr. Astor's variable compensation would be most appropriate at one-third of the increase in sales price.

3) *Character and condition of the company*

This factor focuses on the taxpayer's size, as measured by its sales, net income, or capital value; the complexities of the business; and general economic conditions.

In *Aries Communications*, the Tax Court found that this factor weighed in favor of the IRS. The Tax Court's conclusion was based on the fact that the company had experienced significant operating losses for a number of years (except for the two years in which the major asset sales occurred), despite holding assets that were deemed to be very valuable by purchasers. In the Tax Court's view, this was a sign of poor management. The Tax Court also noted that the company was heavily in debt and at one point had to borrow back the bonus it had paid to Mr. Astor.

4) *Conflict of interest*

This factor examines whether a relationship exists between the company and the employee that would permit the company to disguise nondeductible dividend distributions as deductible compensation payments.

In *Aries Communications*, the Tax Court concluded that this factor weighed in favor of the IRS because Mr. Astor was the sole shareholder of the company. Focusing on the major asset sales, the Tax Court noted that Mr. Astor, as the sole shareholder of

the company, had a significant interest in garnering the highest price for the assets being sold, and then receiving the reward as deductible salary, as opposed to nondeductible dividends. The Tax Court also noted that the company apparently had never in its history made any dividend distributions.

5) *Internal consistency of compensation*

This factor analyzes whether there is an internal inconsistency as it relates to a company's treatment of payments to employees. For example, bonuses that have not been awarded under a structured, formal, consistently applied program may be suspect. This factor also compares the compensation of the shareholder-employee with the compensation of other employees at the company, but only if the services provided are comparable.

In *Aries Communications*, the Tax Court determined that this factor was neutral. On one hand, the Tax Court found that the variable compensation paid to Mr. Astor was not awarded under a structured or formal program, but instead was paid when the company could afford it. In addition, the Tax Court noted that the variable compensation was calculated at the end of the tax year when the company could predict its federal income tax liability before a Section 162 deduction for Mr. Astor's compensation. On the other hand, the Tax Court found that some of the compensation paid to Mr. Astor was for his work in prior years for which he was undercompensated. The Tax Court could not rely on a comparison of Mr. Astor's compensation to any other employees at the company, as their services were not comparable.

6) *Additional factor: The independent investor test*

This factor focuses on the type of return on investment an independent investor would expect to receive in a particular scenario. In other words, an independent investor would not approve of a compensation package that depleted a corporation's assets without appropriately paying the investor.

In *Aries Communications*, the Tax Court held that this factor weighed in favor of the taxpayer. In its analysis, the Tax Court referenced prior case law that found 10%-20% to be a reasonable return on equity. However, the Tax Court determined that a traditional return on equity analysis in this instance would be 'skewed' by the interparty loans and the major asset sales that took place. As an alternative, the Tax Court applied compound growth rates to Mr. Astor's initial investment to determine whether the company would have had sufficient retained earnings after Mr. Astor's compensation was paid in 2004 to provide an independent investor an adequate return on investment. Based on its calculations, the Tax Court determined that the taxpayer could have provided an independent investor a nearly 20% return on investment, which, in its opinion, would be an adequate return.

7) *The Tax Court's overall conclusion*

Based on the multi-factor test outlined in *Elliotts*, the Tax Court held that for the tax year ended August 31, 2004, approximately \$2.7 million of the \$6.9 million was deductible as reasonable compensation and approximately \$4.2 million was nondeductible. In reaching this conclusion, the Tax Court found that Mr. Astor was underpaid with respect to his fixed compensation by approximately \$0.5 million, resulting in a total of \$0.7 million of deductible fixed

compensation, but was overpaid with respect to his variable compensation by approximately \$4.7 million, resulting in a total of \$2 million of deductible variable compensation. The Tax Court determined the amount of deductible fixed compensation by averaging the calculations provided by each expert witness. The Tax Court determined the amount of deductible variable compensation by applying a percentage to the increase in sales price that Mr. Astor was able to obtain during negotiations with the purchaser of the company's assets. Due to the large decrease in total deductible compensation, and a lack of sufficient evidence that the

taxpayer relied on the advice of his tax professional, the Tax Court imposed the Section 6662(a) accuracy-related penalty.

The takeaway

There is no safe harbor or bright-line test for determining whether compensation paid to a shareholder-employee of a closely held corporation is reasonable, and therefore deductible. Instead, the determination is based on an analysis of the taxpayer's specific facts and circumstances. In evaluating a taxpayer's facts and circumstances, the IRS and the courts historically

have employed one or more factors. Despite their inherent limitations, these factors can help corporations and their shareholder-employees proactively evaluate the risks associated with compensation-related planning.

Additional Resources

For a prior PCS Tax Insight on reasonable compensation in the S corporation context, please see: [IRS continues to challenge compensation paid to S corporation shareholder-employees that is not considered reasonable](#).

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC Private Company Services representative, or one of the subject matter professionals listed below:

Private Company Services

Gregg Muresan, *Cleveland*

(216) 875-3504

gregg.muresan@us.pwc.com

William Callahan, *Chicago*

(312) 298-4162

william.b.callahan@us.pwc.com

Gerald Louviere, *Dallas*

(214) 756-1732

gerald.louviere@us.pwc.com

Mark Borden, *Houston*

(713) 356-5645

mark.t.borden@us.pwc.com

Victoria Meyer, *New York*

(646) 471-5030

victoria.meyer@us.pwc.com

Bradley Crowder, *Washington DC*

(703) 918-3757

bradley.e.crowder@us.pwc.com

Ashley Scott, *Atlanta*

(678) 419-1763

ashley.p.scott@us.pwc.com

Mark Stevens, *Cleveland*

(216) 875-3512

mark.r.stevens@us.pwc.com

David VanEgmond, *Detroit*

(313) 394-6531

david.a.vanegmond@us.pwc.com

Jeff Saccacio, *Los Angeles*

(213) 217-3227

jeff.j.saccacio@us.pwc.com

Martin Janowiecki, *Philadelphia*

(267) 330-1588

marty.janowiecki@us.pwc.com

David Zimmerman, *Boston*

(617) 530-5353

david.w.zimmerman@us.pwc.com

Michael Petrecca, *Columbus*

(614) 225-8853

michael.a.petrecca@us.pwc.com

Mark Yarbrough, *Greensboro*

(336) 665-3449

mark.d.yarbrough@us.pwc.com

Robert Biaggio, *Minneapolis*

(612) 596-4747

robert.biaggio@us.pwc.com

Jonathan Malan, *San Francisco*

(415) 498-6152

jonathan.f.malan@us.pwc.com

Mergers & Acquisitions

Horacio Sobol, *Washington, D.C.*

(202) 312-7656

horacio.sobol@us.pwc.com

© 2013 PricewaterhouseCoopers LLP. All rights reserved. In this document, PwC refers to PricewaterhouseCoopers (a Delaware limited liability partnership), which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.

SOLICITATION

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.