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April 16, 2009

Court Addresses "Reasonableness" of Compensation

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Every tax advisor to closely held corporations is confronted from time to time with the question of whether compensation paid to the chief executive or other senior officer of a closely held corporation will be fully deductible under Internal Revenue Code ("Code") section 162(a), which permits a deduction for ordinary and necessary expenses paid or incurred in carrying on a business, including "a reasonable allowance for salaries or other compensation for personal services actually rendered."[1]

If the executive's aggregate compensation does not exceed a reasonable allowance for services rendered, the compensation may be fully deductible by the corporation (subject to various other limitations as to timing and amount not addressed herein). If the aggregate compensation exceeds a reasonable allowance for the personal services rendered by the executive, however, the excess is generally not deductible, but, in most cases, is still includible in the recipient's income, either as compensation or as a constructive distribution with respect to stock (that is, a dividend).

The section 162(a) "reasonable allowance" limitation applies to all corporations (and to non-corporate employers as well). It is unusual for the IRS to raise this issue with respect to a corporation with publicly traded stock, however, because excessive compensation by such corporations is deterred by the fiduciary obligations of the board of directors (generally not controlled by management, at least in theory) and by the ability of shareholders to dispose of their shares in a corporation that is incurring excessive expenditures.

By contrast, where the CEO and members of the CEO's family own all or a controlling position in the shares of a closely held corporation, the ability of minority shareholders to curb excessive compensation is more limited, the board of directors is often comprised of senior executives and/or others unlikely to oppose the CEO in most circumstances, and the tax efficiency of making payments to the CEO as (generally deductible) compensation, rather than as dividends subject to two levels of tax, may be of paramount importance.

The IRS frequently asserts in such circumstances that the aggregate amount paid to the CEO as compensation is excessive in relation to the services rendered, with the excess being typically characterized as a dividend. The IRS and at least some courts have applied multi-factor tests in determining whether or not compensation is in fact excessive, with the relevant factors including the type and extent of the services rendered, the scarcity of individuals qualified for the position, the qualifications of the employee, and the performance of the employee and the corporation as a whole.[2]

By contrast, the Court of Appeals for the Seventh Circuit, like some other appellate courts, has focused more on a single standard known as the "independent investor test." Under that test, a presumption arises that compensation is reasonable if the stockholders are receiving a rate of return on their investment not less than the rate of return they would obtain through other investments with similar levels of risk.[3] This presumption may be rebutted by evidence that the success of the corporation is attributable to other factors unrelated to the executive's efforts, such as (for example) evidence of an unexpected discovery of oil on the company's property or that the executive does little or no work.

In *Menard, Inc. v. Commissioner*,[4] the Seventh Circuit, reversing the Tax Court, recently concluded that the independent investor test was controlling and that the compensation of the CEO of a closely held corporation was fully deductible, notwithstanding a variety of circumstances that, in the view of the Tax Court, justified a different result, including evidence that the CEO received much more compensation for the year at issue than the CEOs of publicly traded competitors.

Facts in Menard

John Menard ("JM") owned all of the voting stock and approximately 56% of the nonvoting common stock of Menard, Inc. ("Menards"), with family members and trusts holding the remaining nonvoting shares, and served as

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President and CEO of the corporation. Menards was primarily engaged in the retail sale of hardware, building supplies, and similar items, through approximately 160 retail stores in the Midwest, and was the third largest home improvement chain in the U.S.

Although highly successful, with $315,326,485 of taxable income being reported on the Form 1120 tax return of Menards for the fiscal year ended January 31, 1998 (FYE 1998), the corporation had never paid dividends.

Menards generally paid low base salaries to its executives, supplemented with large cash bonuses. In 1973, the board of Menards adopted an annual bonus plan under which JM would receive a bonus equal to 5% of the net income of the corporation before taxes. For FYE 1998, the bonus so computed was $17,467,800 and JM's total compensation for the year was $20,642,585. The bonus was subject to a reimbursement agreement under which JM would repay to Menards any portion of the bonus that was disallowed by the IRS as a deduction.

Following an audit, the IRS determined that JM's compensation for JM for FYE 1998 was "unreasonable and excessive" and disallowed approximately $19,000,000 of Menards' claimed deduction for compensation. The Government contended that this amount was not deductible as compensation and was a disguised dividend. Menards filed a petition with the Tax Court contesting the IRS's determination of additional tax due.

Discussion in Tax Court Opinion

In the Tax Court, Menards demonstrated that its corporate return on equity for the year at issue significantly exceeded that of Home Depot, Lowe's, and other large retailers with which Menards competed. In light of that fact, the Tax Court agreed that the compensation paid to JM satisfied the independent investor test as previously articulated by the Seventh Circuit Court of Appeals (to which appeal in the case lay).

The Tax Court focused, however, on expert testimony and other evidence that compared the compensation of JM to the compensation paid to other CEOs working for comparable retailers and found that JM's compensation was much higher than the compensation of CEOs of Menards' competitors, some of which were substantially larger than Menards. The Tax Court concluded that the discrepancy was not adequately justified on the basis of the high rate of return and relative profitability of Menards, but, rather, suggested that a portion of JM's compensation was not "reasonable."

The Tax Court opinion also cited, as circumstances favoring characterization of a portion of JM's compensation as a disguised dividend, Menards' failure to have ever paid a dividend, despite its high rate of growth over the years, and the fact that the 5-percent bonus was paid in a lump sum, rather than over the year as services were performed. The court referred to the 5-percent, profit-based, year-end bonus paid to a majority shareholder as "practically no different from a dividend."

The Tax Court also found the agreement by JM to reimburse Menards for any portion of the bonus ultimately disallowed as a deduction suggested knowledge that the compensation exceeded the reasonable compensation standard of section 162(a) and was intended in part as a disguised dividend.

Ultimately, the Tax Court determined a reasonable amount of compensation for JM by applying a formula that, first, multiplied the compensation for the same period received by the CEO of Home Depot, in some respects the closest competitor in terms of types of merchandise and rate of return, namely $2,841,307, by the fraction determined by dividing Menards's percentage return on equity (18.8) by Home Depot's return on equity (16.1), or $3,317,799, and, second, multiplied that amount by the 2.13 ratio of the compensation of the higher-paid CEO of Lowe's to that of the CEO of Home Depot, yielding a total of $7,066,912. Accordingly, the court determined that the excess of the compensation of JM for FYE 1998 over $7,066,912 was not deductible.

Court of Appeals Analysis

On appeal, the Court of Appeals for the Seventh Circuit, in an opinion by Judge Posner, concluded that the entire amount of compensation for JM for FYE 1998 was deductible.

The opinion states that the reimbursement agreement between JM and Menard should not be viewed as indicative of an intent to pay a disguised dividend, but simply as prudent management, in light of the tendency of the IRS and the Tax Court to analyze the excessive compensation issue on the basis of a "totality of the circumstances" approach.

The opinion also noted that the 5% bonus policy for JM had been adopted many years previously and consistently followed, and that the board that approved the original bonus plan included a non-family shareholder who voted for the bonus plan (although the board as in existence in 1998 consisted solely of JM, a younger brother (who also worked for Menards), and the company treasurer).

The Court of Appeals also concluded that the bonus arrangement did not resemble a dividend in form, given that a dividend is generally paid as a fixed dollar amount per share rather than as a percentage of earnings. This distinction by the Court of Appeals seems to elevate form to a unwarranted degree; on the other hand, the prior assertion by the Tax Court that the bonus looked like a dividend seemed unwarranted as well, given that executive bonuses are frequently determined as a percentage of the profits of a corporation or of a corporate division.

The opinion also noted that the fact that the bonus was paid in a lump sum at the end of the year did not make it appear less like compensation or more like a dividend, since bonuses are typically paid in a lump sum once earnings for the year are known, whereas dividends, in the view of the Court of Appeals, are usually paid quarterly (although that is frequently not the case for a closely held corporation).

The fact that the board had not sought any outside advice as to appropriate compensation for JM had been

noted as potentially favoring characterization of the bonus as something other than compensation. The opinion remarked, however, that "the only point of doing that would have been to provide some window dressing in the event of a challenge by the IRS. [JM] doubtless has a strong opinion of what he is worth to the company and would not pay a compensation consultant to disagree."

More substantively, the Court of Appeals emphasized that certain circumstances that exist in many closely-held corporations -- such as the control of the board by the CEO (where the CEO owns a majority or more of the stock) or the CEO's strong incentive, as a major shareholder, to manage effectively regardless of the amounts paid as compensation -- should not preclude such a corporation from determining and deducting a reasonable allowance for compensation in the same manner as other corporations.

It was also noted that JM's average annual compensation over the years was substantially less than $20 million, suggesting that a bonus which for one year may be at the upper limits of reasonableness may be more justifiable when paid pursuant to an arrangement followed in many years for which smaller bonuses were paid to the CEO notwithstanding comparable levels of effort and performance. Finally, the Court of Appeals criticized the Tax Court's computation of a reasonable amount of compensation for JM as highly arbitrary and as not taking into account factors such as the likely broader responsibilities of JM as compared to an equivalent CEO of a publicly traded corporation with a larger board of directors and staff.

Observations

The Court of Appeals decision merits careful review by anyone concerned with this issue as a forceful discussion of circumstances that should -- and should not -- be taken into account in determining whether the compensation paid to an executive is deductible under the "reasonable allowance" standard.

Notwithstanding the taxpayer's victory in this case, however, it should be kept in mind that a more independent board of directors that includes individuals who are not employed by the company or members of the CEO's family, and the use of a compensation consultant, may increase the likelihood of prevailing on issues of this nature; that other Courts of Appeals may not fully share Judge Posner's views on these issues; and that there may be some circumstances in which even this court would likely conclude that meeting the independent investor standard is not sufficient to cause all of the compensation paid to a shareholder/CEO to be deductible.

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[1] IRC § 162(a)(1).

[2] *See*, *e.g.*, *Rapco, Inc. v. Commissioner*, 83 F.3d 950 (2d Cir. 1996).

[3] *See Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999), and cases cited therein.

[4] 103 AFTR 2d 2009-1280, Dkt. no. 08-2125 (7th Cir., March 10, 2009), *reversing* TC Memo 2004-207 (2004).

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