Reasonable Compensation Issues-Multifactor Tests: Additional Decisions

Brewer Quality Homes, Inc. v. Commissioner

Introduction. Another case that weighed multiple factors in determining whether compensation was reasonable, and therefore deductible, is *Brewer Quality Homes, Inc. v. Commissioner*.[1]

The Facts of the Case. Brewer Quality Homes (BQH) was a closely held corporation. Brewer, BQH's founder and principal officer and his wife each owned 50%. Brewer exercised control over the business at all times and performed virtually all the company's job functions, although the company had 16 employees. He worked six to seven days a week, putting in about 70 hours per week in the early years of the business and about 60 hours per week in 1995 and 1996, the years at issue in the case.

In 1995, BQH paid Brewer $62,186 in salary over the course of the year and $700,000 as a bonus at the end of the year. In 1996 BQH paid him $63,559 in annual salary and $800,000 as an end-of-year bonus. Brewer's compensation in 1995 represented 82% of BQH's taxable income for that year, while his 1996 compensation accounted for 85% of BQH's total taxable income for 1996. During 1995 and 1996, the company paid no dividends and never had a retirement or profit-sharing plan for Brewer. The IRS determined that BQH could deduct only $604,117 for 1995 and $485,966 for 1996.

Expert Testimony at the Tax Court. Both parties presented expert witnesses. BQH's experts opined that Brewer's compensation was reasonable and the IRS's expert that it was not.

Only Brewer's expert used statistical data, based on the financial ratios found in Robert Morris Associates (RMA) surveys, including a ratio for executive compensation to company sales, as a measure of reasonable compensation. The expert determined that Brewer "achieved exceptional financial performance" at BQH, justifying compensation above the 75th percentile and as high as the 90th percentile.

The IRS's expert criticized this use of the ratios, claiming, among other things, that the RMA data might not be "consistent with arm's length practices." However, the IRS expert

[1] *Brewer Quality Homes, Inc. v. Commissioner*, T.C. Memo 2003–200 (July 10, 2003).

did not provide anything to back up his suspicion, nor did he offer any other data focusing more directly on the retail mobile home industry.

Tax Court's Nine-Factor Analysis. The Tax Court's reasonableness inquiry was governed by the nine-factor test set forth in *Owensby & Kritikos, Inc. v. Comm'r,* 819 F.2d 1315 (5th Cir. 1987).

Factor One. The Court observed that Brewer was highly qualified and determined that this factor weighed in favor of a relatively high compensation for Mr. Brewer.

Factor Two. The Court considered the nature, extent, and scope of Mr. Brewer's Work. The Court found that Mr. Brewer worked long hours and that his hard work was the driving force behind BQH's success, noting Mr. Brewer's ability to fulfill numerous roles, including serving as BQH's president, chief financial officer, chief executive officer, general manager, sales manager, loan officer, credit manager, purchasing officer, personnel manager, advertising manager, insurance agent, and real estate manager. The Court also determined that through Mr. Brewer's "enthusiasm, hard work, and dedication, he built [BQH] into a successful enterprise." As such, the Court concluded that this factor weighed in favor of a high compensation for Mr. Brewer. Tempering this finding, however, this Court has observed that "nonetheless, limits to reasonable compensation exist even for the most valuable employees."

Factor Three. The Court examined the size and complexity of BQH. recognized the growth BQH made over the years, especially noting the substantial success it enjoyed beginning in the early 1990s. The Court cited BQH's rise in the national rankings among retailers for BQH's products as evidence of this fact. The Court also noted the different aspects of BQH's operations, specifically observing BQH's foray into the financing and insurance aspects of sales. In sum, the Court made a determination that this factor favored a higher compensation for Brewer.

Factor Four. The Court compared Brewer's salary with gross and net income The Court found that the claimed compensation BQH paid to Mr. Brewer in 1995 and 1996 constituted 8.5% and 8.7%, respectively, of BQH's gross sales and 82% and 85%, respectively, of BQH's taxable income. The Court employed financial ratios in its various computations from the RMA report and determined that the RMA study of comparable companies revealed a median value of compensation as a percentage of gross sales as 2.3% for 1995 and 1.8% for 1996. Nevertheless, the Court did not rely on the median value in reaching its decision, relying instead on the values accorded to the 90th percentile of officer compensation payments, a reflection of the Court's earlier finding regarding BQH's financial successes during the years in question. The Court even accepted BQH's expert witness's suggestion that the percentage of gross sales for 1995 and 1996 were 6.0% and 6.3%, respectively. Nonetheless, the Court determined that Brewer's compensation percentages were substantially higher than the figures urged by BQH's expert, thus leading the Court to conclude that reasonable compensation would have been significantly less than BQH's actual payments to Brewer.

After making this determination, the Court multiplied BQH's sales by the corresponding RMA ratio for each year in question to arrive at the appropriate compensation amounts for the services Brewer performed for BQH: $520,000 in 1995 and $600,000 in 1996. The Court thereafter added $5,000 to the 1995 amount to account for

Brewer's guarantee of a bank loan to BQH that year and added 5% of Brewer's newly calculated compensation to make up for the absence of retirement benefits. The total amount of reasonable compensation for Mr. Brewer as determined by the Court was ultimately $610,000 for 1995 and $630,000 for 1996.

Factor Five. The Court considered the prevailing general economic conditions. The Court noted in its findings of fact that BQH had survived several economic downturns, evidencing BQH's resilience. The Court specifically recognized Brewer's efforts in ensuring BQH's ability to survive those conditions, and as such found this factor favored a relatively high compensation.

Factor Six. The Court compared salaries with distributions to stockholders. In 1993, BQH distributed $116,100 to its only two shareholders (Mr. and Mrs. Brewer). In 1994, BQH distributed $320,949 to the Brewers. Up to the end of the 1996 fiscal year, the 1993 and 1994 distributions were the only ones made by BQH. The Court was troubled by the fact that the profitability of BQH was considerably higher in 1995 and 1996 than in previous years, yet BQH did not make any distributions whatsoever. By paying compensation to Brewer in the amounts BQH did in 1995 and 1996, the Court concluded that this factor weighed heavily in favor of a low compensation for Brewer.

Factor Seven. The Court considered compensation for comparable positions in comparable concerns. The Court determined that Brewer received compensation higher than those executives in comparable companies. The Court relied upon the RMA data, which systematically draws from numerous companies across the industry and permits objective comparisons between executive compensation and company performance.

Factor Eight. The Court considered the salary policy of BQH as to all of its employees. BQH did not maintain an official salary policy for any of its employees, including Brewer. The Court expressed concern that because Brewer essentially controlled BQH, he was able to set his own compensation. While the IRS conceded that BQH paid its employees' salaries equal to or greater than those paid by its competitors, it argued that the wide disparity between the salary paid Brewer and the next highest-paid employee supported a low compensation amount.

Factor Nine. The Court considered the amount of compensation paid to brewer in previous years. BQH argued before the Court that it underpaid Mr. Brewer in previous years, particularly in 1992 and 1993. The Court rejected this argument, finding persuasive the absence of any corporate minutes reflecting any mention of BQH's intention to compensate Mr. Brewer for past years of undercompensation. Moreover, the Court noted that neither of BQH's experts could provide any credible testimony regarding the alleged underpayments or the specific years in which they occurred, stating that BQH's "theory of compensation for prior services [appeared to be] only an afterthought developed at a time when the reasonableness of the compensation was already under attack."

RMA Ratios. Ultimately, the Court used the RMA ratios to determine reasonable compensation. The Court acknowledged that the RMA ratios left "much to be desired" but used them nonetheless because they were the only statistical information presented (the "only game in town," in the Court's words). Using these ratios, the Court disallowed

$152,186 of BQH's 1995 deduction and $233,559 of its 1996 deduction. On appeal, the Fifth Circuit affirmed the Tax Court's decision as not clearly erroneous.[2]

Summary and Conclusion. This case shows the importance of using well-supported statistical data. It is also a guide to the factors the Tax Court will weigh in determining whether compensation is reasonable and deductible.

O.S.C. & Associates, Inc. v. Commissioner

Introduction. In *O.S.C. & Associates, Inc. v. Commissioner*,[3] the U.S. Court of Appeals for the Ninth Circuit presented a hidden danger in a strategy used by some owners of closely held corporations—that is, those who pay themselves excessive deductible compensation to avoid paying nondeductible dividends.

In this case, the usual taxpayer fallback position in reasonableness of compensation cases—in which the stockholder-employees expected to be able to at least deduct the reasonable compensation portion, if challenged—backfired. This occurred when, as a result of the disguised dividend taint, the Appeals Court denied a sizable portion of what the IRS had already admitted was reasonable compensation.

The Facts of the Case. As a result of their hard work and unique skills, the two stockholder-employees owned a successful silk-screening business. The taxpayer business, originally purchased for $180, grew from a kitchen table to a 65,000 square-foot plant, with over 200 employees. The taxpayer corporation grossed over $13 million a year.

During this increasingly successful 20-year journey, the owners incorporated, with (1) one becoming president and chief executive officer having 90% of the company's stock and (2) the other becoming vice president with the remaining 10% of the company's stock.

The taxpayer corporation formally adopted an incentive compensation plan. This compensation plan had the purpose of recognizing the two shareholders for their contributions to the business. The employee/shareholders were the plan's only participants. Payments were made according to stock ownership. As a practical matter, this stock ownership-based allocation resulted in the corporation distributing nearly all of its net income as incentive payouts to the two owners in the years in question.

The Court's Two-Part Test. The Appeals Court, citing an earlier case,[4] applied a two-prong test to determine the deductibility of payments to the stockholder-employees. The two-part test included: (1) reasonableness of amount and (2) compensatory intent.

In the earlier case, the Ninth Circuit Court of Appeals acknowledged that most courts concentrate on the first prong—that is, reasonable amount—using that result to infer compensatory purpose. The Appeals Court, however, held that, "In the rare case where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness."

[2] *Brewer Quality Homes, Inc. v. Comm'r*, 122 Fed. App'x 88 (5th Cir. 2004).

[3] *O.S.C. & Associates, Inc. v. Commissioner*, 187 F.3d 1116 (9th Cir. 1999), aff'g T.C. Memo 1997–300 (June 30, 1997).

[4] *Elliots, Inc. v. Commissioner*, 716 F.2d 1241. (9th Cir. 1983).

In this case, however, the Appeals Court observed that this was just such a case where reasonableness alone was not sufficient to satisfy the compensatory intent prong.

Was the Compensation Disguised Dividends? As evidence that the corporation's compensation plan allocations were not intended as compensation but, rather, as disguised dividends, the Appeals Court noted that the percentages of the corporation's net income paid to its two stockholder-employees ranged from 81% to 94%. The Court concluded that this was a strong indication that profits were being siphoned out of the taxpayer corporation disguised as compensation.

In addition, the Appeals Court noted that the taxpayer corporation had never paid or declared a dividend. This was relevant considering the taxpayer corporation's history of high profitability. Also, the 90% employee/owner had rejected professional advice to pay dividends.

Furthermore, the taxpayer corporation's accountant manipulated the actual implementation of the compensation plan in order to increase the allocations above what the plan would have authorized.

Finally, the Appeals Court determined that the design of the compensation plan was inconsistent with compensatory intent because: (1) the plan applied only to the corporation's shareholders and no other employees; (2) the payments were calculated with reference to their proportionate stock ownership; and (3) the method of calculation was not based on the value of services rendered to the corporation but was structured to distribute every dollar of net profit.

Summary and Conclusion. This case provides a very effective road map as to what a closely held business owner should not do in order to protect the "reasonable" component of an excessive compensation deduction.

Law Offices—Richard Ashare, P.C. v. Commissioner

Introduction. In *Law Offices—Richard Ashare*,[5] the Tax Court provides guidance to professional corporations involved in conflicts with the IRS regarding whether substantial amounts of compensation paid to their professional employees (e.g., doctors, lawyers, consultants, etc.) can be deducted by the corporation as reasonable compensation expense.

In this case, the Court gave significant latitude to the professional corporation in allowing it to prove that a $1.75 million payment made to an attorney in a single year was intended solely as compensation. And, as reasonable compensation, the entire $1.75 million payment was totally deductible by the corporation.

The Court's reasonable compensation finding is particularly noteworthy to professional firm owners. This is because the taxpayer corporation reported a taxable loss in the amount of $1,857,933 for the year of the $1.75 million compensation payment.

The Facts of the Case. Richard Ashare was the taxpayer corporation's sole shareholder attorney. He was also the taxpayer corporation's only professional employee. His compensation related exclusively to one class-action case.

[5] *Law Offices—Richard Ashare, P.C. v. Commissioner*, T.C. Memo 1999–282 (Aug. 24, 1999).

The taxpayer corporation achieved a $70 million settlement after 15 years of litigation. The settlement included $12,567,000 in legal fees paid to the corporation over four years.

The taxpayer corporation paid the shareholder attorney $12,242,000 in salary over five years. This included the $1.75 million salary that was the subject of the IRS challenge.

The Tax Court's Decision. In a surprising taxpayer victory, the Court found that the $1.75 million payment to the attorney/employee met the first test for deductibility (i.e., reasonableness of amount). This was because the amount was reasonable for compensation paid by a personal service corporation, such as the law firm in the present case, to its key employee for his services. The employee's qualifications for his position with the employer firm justified high compensation.

In addition, the Court noted the fact that the attorney was vital and indispensable in the operation of the employer's business. The nature of the employer's business was complex and highly specialized, requiring this employee's expertise.

The Court warned, however, that the fact that the $1.75 million was reasonable did not necessarily mean that it was fully deductible to the employer. Under the second test for deductibility, a deduction for compensation is allowed only to the extent that the compensation is paid for services rendered by the employee—in or before the year of payment.

The Court concluded that the $1.75 million met this second test for deductibility. This was because it was paid to the attorney to compensate him for his work on the class litigation for which the employer received over $12 million in court-ordered legal fees.

The Court also noted that the employer's board of directors determined that the employee was entitled to receive the $1.75 million in compensation for his past and present services on one case. That one case constituted the firm's work during the years of the employee's tenure. The taxpayer corporation's board, through the exercise of sound business judgment, resolved that the employee was entitled to the $1.75 notwithstanding the IRS's conclusions to the contrary.

The Court was aware the corporation's board of directors was made up of the practitioner himself, his wife, and his long-time tax adviser. Nonetheless, the Court refused to second-guess the taxpayer corporation board's determination.

Summary and Conclusion. In its decision, the Tax Court noted that scrutiny of the facts is appropriate in a case such as this one—that is, where the employer payer is controlled by the payee/employee. Nevertheless, the Court's published opinion did not include any of the usual analysis of whether the $1.75 million paid to the corporation's sole shareholder employee should have been characterized as a nondeductible dividend rather than as deductible compensation.

Alpha Medical, Inc. v. Commissioner

Introduction. In *Alpha Medical, Inc. v. Commissioner*,[6] the Sixth Circuit U.S. Court of Appeals reversed the judgment of the Tax Court.

The Tax Court held that $2.3 million (of the $4.4 million actual compensation) paid to the president and sole shareholder of a company could be claimed as a business expense deduction.

Although the Sixth Circuit essentially agreed with the Tax Court's conclusions with respect to the individual factors examined to determine the reasonableness of the compensation, the Appeals Court concluded that the compensation was reasonable because it did not exceed the amount needed to remedy undercompensation in prior years.

The Facts of the Case. Mr. William Rogers incorporated Alpha Medical Management, Inc., in Tennessee with an initial capital contribution of $1,000. The company provided management services to home health care agencies and hospitals with home health care departments.

Mr. Rogers was the president, sole director, and sole shareholder of the company through the year in question. Mr. Rogers, who earned a doctorate degree in pharmacology, founded a durable medical equipment business and a drugstore chain, which he had previously sold.

After selling the medical equipment business, Mr. Rogers turned down a management position in California with an annual salary of over $1 million so that he could stay in Tennessee and concentrate on developing Alpha Medical Management, Inc., as a successful business concern.

The shareholders' equity of Alpha Medical increased to $3.4 million for the year in question, from $97,000 four years earlier.

The salary of Mr. Rogers increased to $4,439,180 as deductible compensation and $1,500 as nondeductible dividends for the year in question, from $67,000 four years earlier.

The compensation of Mr. Rogers was equal to 64.6% of the taxpayer's net taxable income before the deduction of Mr. Rogers's compensation ($6,871,433) and 44.9% of gross receipts ($9,880,760).

The IRS allowed only $400,000 as a deduction for reasonable compensation of Mr. Rogers.

The Tax Court's Decision. The Tax Court examined nine relevant factors in order to determine the reasonableness of Mr. Rogers' compensation and concluded for each factor whether it favored the taxpayer, favored the Commissioner, or was neutral.

The nine factors considered by the Tax Court are listed below.

- Employee's qualifications—favored taxpayer.
- The nature, extent, and scope of the employee's work—favored taxpayer.
- The size and complexities of business—favored taxpayer.
- A comparison of salaries paid with gross income and net income—favored IRS.
- The prevailing general economic conditions—favored IRS.

[6] *Alpha Medical, Inc. v. Commissioner*, 172 F.3d 942. (6th Cir. Apr. 19, 1999), rev’g T.C. Memo 1997–464 (Oct. 14, 1997).

- Comparison of salaries with distributions to stockholders—favored taxpayer.
- The prevailing rates of compensation for comparable positions in comparable concerns—neutral.
- The salary policy of the taxpayer as to all employees—favored IRS.
- The amount of compensation paid to the employee in previous years—favored taxpayer.

The Tax Court concluded that the compensation paid to Mr. Rogers was in part unreasonable, agreeing with neither the taxpayer nor the IRS. The Court held that $2.3 million constituted reasonable compensation for Mr. Rogers for services rendered the year in question and prior years.

The Appeals Court Decision. The Appeals Court decision noted that the Tax Court did not explain how it reached the $2.3 million figure and that it appeared to split the difference between the IRS's original position and the taxpayer's position.

The Appeals Court reviewed the nine factors considered by the Tax Court and agreed with the conclusions with respect to all but one. Regarding the salary policy of the taxpayer as to all employees, the Tax Court stated that this factor pointed to the conclusion that Mr. Rogers' compensation was in part unreasonable. This conclusion was based on the great disparity between the compensation of the sole shareholder, Mr. Rogers, and the nonshareholders and the fact that his compensation plan was not the result of a longstanding arm's length agreement. The Appeals Court disagreed "in light of the fact that Rogers was grossly underpaid for several consecutive years." Furthermore, the Appeals Court noted that, in five years, Mr. Rogers had taken the company from nothing to a net profit of nearly $7 million, stating: "In this situation, the factual record and some notion of parity with other highly successful executives requires a different result from that reached by the Tax Court."

The Appeals Court reversed the judgment of the Tax Court, acknowledging Mr. Rogers' qualifications, responsibility for the success of the company, long hours, risks assumed in founding and developing the company, and opportunity cost in turning down the $1 million-plus position in California.

The Appeals Court concluded that Mr. Rogers' "compensation ... did not exceed the amount needed to remedy prior years of undercompensation and was therefore reasonable."

Summary and Conclusion. *Alpha Medical, Inc.* demonstrates that a level of compensation to a sole shareholder that may seem unreasonable at first glance may, in fact, be reasonable when all factors are considered, most notably under compensation in prior years.

Beiner, Inc. v. Commissioner

Introduction. The issue in *Beiner, Inc. v. Commissioner*[7] was whether the taxpayer could deduct compensation of $1,087,000 and $1,350,000 that it claimed for years 1999 and 2000

[7] *Beiner, Inc. v. Commissioner*, T.C. Memo 2004–219 (September 28, 2004).

paid to its sole shareholder and corporate officer who served as chief executive officer (CEO), chief financial officer, president, secretary, and treasurer.

The Facts of the Case. The taxpayer was a wholesale distributor of motor controls (parts) manufactured by Allen-Bradley. During the relevant years, Allen-Bradley sold its parts only to its authorized distributors and to original equipment manufacturers (OEMs). The authorized distributors sold the parts that they purchased from Allen-Bradley directly to end users. Allen-Bradley sold its parts to OEMs, not for resale, but to incorporate the parts into equipment that they manufactured and sold as finished products.

The taxpayer was neither an OEM nor an authorized distributor of Allen-Bradley parts. The taxpayer bought and sold Allen-Bradley parts in a bootleg market for those parts. During the subject years, the taxpayer purchased Allen-Bradley parts primarily from three OEMs. These OEMs intentionally purchased more parts than needed for their manufacturing process and resold the extra (surplus) parts to the taxpayer at prices far less than the prices that the authorized distributors paid Allen-Bradley for the same parts. During the relevant years, the taxpayer also purchased Allen-Bradley parts at fire sale prices from distressed companies that had either overbought the parts for their own needs or gone out of business.

The three OEMs sold their surplus parts to the taxpayer in violation of an understanding that they had with Allen-Bradley to not sell those parts other than as part of their finished products or, in some cases, as replacement parts for those products. Over the years, The CEO had developed a relationship with the three OEMs such that they sold their surplus parts to the taxpayer at the risk of Allen-Bradley's declaring that it would no longer sell parts to them or that it would do so only at inflated prices. The three OEMs benefited from purchasing surplus parts and selling them to the taxpayer in that they paid less per unit when they purchased a greater quantity of parts that, in turn, increased their profit margins on their sale of the finished products. The taxpayer also improved the OEMs' cash flows because it paid very quickly. The three OEMs would have stopped selling their surplus parts to the taxpayer had the CEO become disaffiliated with it.

The Tax Court's Decision. Applying the five-part test used in the Ninth Circuit (because the case would be appealable there),[8] the court found that the CEO was primarily responsible for the taxpayer's business success. Although the CEO did not work exceptionally long hours for the company, nor did he devote 100% of his time to the taxpayer's business, the CEO arranged what the court felt was the most important element of the taxpayer's business—the purchase of Allen-Bradley motor parts at prices less than those paid by the authorized distributors. But for the CEO, the taxpayer would not have been able to obtain its inventory at the discount prices that allowed it to function as profitably as it did. In fact, the special relationships that the CEO developed with the three OEMs allowed the taxpayer to report greater gross profit margins and returns on sales and investment than virtually any other similar public company for which data was available for 1999 and 2000.

[8] For a detailed discussion of the Ninth Circuit's five-part test, see, e.g., *LabelGraphics, Inc. v. Commissioner*, T.C. Memo 1998–343 (Sept. 28, 1998), discussed in text.

A compensation expert opined that the taxpayer was substantially more profitable than virtually all of the 34 companies he sampled in terms of the ratio of gross profit to sales. The taxpayer's ROE during the subject years was 28.1% and 50.1%, respectively. The Court determined that, although the CEO had compensation that was much greater than the separate or collective compensation of other employees, such compensation was justified because the taxpayer's profits were derived almost exclusively through the CEO's efforts. The Court also determined that a hypothetical inactive independent investor would consider each factor favorably to require the payment of the disputed compensation to the CEO in order to retain his services during each of the subject years.

Based on the compensation expert's data, however, the Court determined that the CEO's compensation for 1999 was unreasonable by $180,260. Nonetheless, the Court declined to impose a penalty because enough of the taxpayer's profits remained in equity for that year to have constituted a meaningful return to a hypothetical inactive independent investor.

Summary and Conclusion. As in some of the other reasonable compensation cases covered in this section, this case shows that it is critical to analyze the facts of each case carefully. In this case, the CEO's worth to the company was so great that it justified paying him, during the respective subject years, 31.3 and 38.7% of its gross receipts and 88.3 and 69.9% of its net income (adding back compensation).

E.J. Harrison and Sons, Inc. v. Commissioner

Introduction. The issue in *E.J. Harrison and Sons, Inc. v. Commissioner*[9] was whether the amounts paid by the company to an officer-shareholder were deductible as reasonable compensation during the tax years at issue.

The Facts of the Case. Mr. and Mrs. Harrison entered into the waste pickup and disposal business in 1932. In 1967, they incorporated the business as E.J. Harrison and Sons, Inc. Mr. Harrison died in 1991, and Mrs. Harrison was elected president and chairman of the board, titles she held throughout the audit years of 1995 to 1997. During these years, she worked 40 or more hours per week.

Mrs. Harrison's work consisted primarily of: (1) attending board meetings and reviewing and voting on major proposals put forward by her sons, who, together, were responsible for the company's financing and operations; (2) community public relations activities on the company's behalf; and (3) acting as a co-guarantor on company bank loans.

The amounts of Mrs. Harrison's compensation disallowed by the IRS as "unreasonable and excessive compensation" were $806,467, $762,019, and $541,325, for 1995, 1996, and 1997, respectively. The company never paid dividends.

Expert Testimony at the Tax Court. Although both parties offered expert testimony to support their positions, the Court excluded the report of the taxpayer's expert, because it was not "based upon sufficient facts or data" and because he did not apply "principles and methods [for determining the reasonableness of Mrs. Harrison's compensation] reliably to

[9] *E.J. Harrison and Sons, Inc. v. Commissioner*, T.C. Memo 2003–239 (August 13, 2003).

the facts of the case." One-third of the report consisted of legal analysis and arguments, including citations and discussion of case law, and virtually all his factual conclusions on which he based his opinion were either unsupported or incorrect.

The IRS's expert, a certified management consultant specializing in compensation planning, likened Mrs. Harrison's services to those of an outside board chair and opined that her appropriate compensation should be "the median compensation paid to board chairs during the audit years by other companies with comparable sales revenues as derived from surveys conducted by [the] Economic Research Institute [ERI]." He described the ERI surveys as "broadly based" and said that he used a "large-sample survey." He declined to rely on the results of a narrower survey involving only five board chairs.

The Tax Court's Decision. The Tax Court analyzed the IRS expert's opinion in conjunction with the previously described five-factor test set out by the Ninth Circuit.[10] Regarding Mrs. Harrison's role in the company, the Court noted that "[w]hatever lingering effect Mrs. Harrison's conservative business philosophy may have had on the decision-making process, it appears that her responsibility for and influence over the actual decisions of the board were sharply limited in practice ... The overall picture that emerges is of a company run during the audit years (and for many prior years) by Mrs. Harrison's sons..." The Court found that her titles did not reflect her actual status within the company and that her role as an "essentially compliant [board] member" justified only a small fraction of her compensation.

Similarly, the Court found that, although Mrs. Harrison projected a positive corporate image in the community, her public relations activities did not contribute directly to the company's sales and profits. The Court also dismissed Mrs. Harrison's guaranties as providing any support for her compensation, stating that the evidence did not establish any significant financial risk to her or what amount, if any, would constitute reasonable compensation. The Court was persuaded that the guarantees were given to protect the shareholders' ownership interests in the company.

Despite the favorable character and condition of the company, the Court said that Mrs. Harrison's limited management role during the audit years rendered this factor "of little or no relevance." Although the taxpayer fought the implication that Mrs. Harrison's compensation was disguised dividends, the Court said that the evidence strongly suggested such a conclusion, largely because the company's profits for the audit years were primarily attributable to the efforts of her sons. The Court concluded that an independent investor in the company would object to the size of the payments, even assuming, as the taxpayer argued, that the company's retained earnings for the audit years were a reasonable return on shareholder equity compared with that of comparable companies.

Finally, the Court observed the large discrepancy between Mrs. Harrison's compensation and that of the highest-paid non-shareholder employee, $79,639, which was less than 10% of the amount paid to Mrs. Harrison that same year. Nothing in the evidence explained this difference.

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[10] For a discussion of these five factors, see, e.g., *LabelGraphics v. Commissioner*, T.C. Memo 1998–343 (1998), aff'd 221 F.3d 1091 (9th Cir. 2000), discussed in text.

For external comparisons, the Court liked the IRS expert's analogy of Mrs. Harrison as an outside board chair. It concluded, however, that her position in the company afforded her "additional benefits ... (whether tangible or intangible)" that were not available to the average board chair. Accordingly, the Court added an 80% premium over the median compensation paid to an outside board chair to reflect Mrs. Harrison's reasonable compensation. Thus, the Court agreed with the IRS that she was overcompensated for her services and disallowed part of the deduction.

Summary and Conclusion. This case shows that the Tax Court will, in appropriate cases, be persuaded by analogies, supported by factual analysis, to determine reasonable compensation.