Funny Money: Deducting "Reasonable" Compensation

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Anyone who goes to Tax Court (and most tax practitioners do at one time or another) knows that Tax Court judges are tax professionals. They know a lot of tax law, and that means they can be tough on taxpayers. It therefore can be a little bit satisfying (with or without guilt) when you see a Circuit Court opinion in which the Tax Court gets rebuked for a rigid—or possibly even wrong—view of the tax law. That certainly happened with Judge Posner's harshly worded opinion in *Menard, Inc.,* No. 08-2125 (7th Cir. Mar. 10, 2009), Doc 2009-5325, 2009 TNT 46-9.

This was a reasonable compensation case, something that may well sound like an oxymoron, at least when we see AIG and other bailed-out companies rewarding executives with outsize bonuses. Just how much compensation is reasonable, anyway?

To be sure, the historical roots of the reasonable compensation doctrine are not hard to fathom, despite current views at some notable Wall Street excesses. In the context of closely held companies, the obvious dichotomy between the tax treatment of deductible compensation and nondeductible dividends is patent. It is perhaps therefore not surprising that many decades ago, cases litigating the line between what is reasonable and what is not were fomented.

Compensation Contracts

You may not have shopped there, but Menards is the country's third largest home-improvement chain, trailing only Home Depot and Lowe's. In 1998, Menards had 160 stores in nine states, reporting revenue of $3.42 billion, and taxable income of $315 million. John Menard is the controlling shareholder and CEO, receiving a base salary of the decidedly not whopping $157,000. Since 1973, the patriarch has received an annual bonus equal to five percent of the corporation's net income before taxes. The compensation contract includes a savings clause, requiring Mr. Menard to repay the company for any portion of his compensation for which the IRS disallows a deduction to the company.

In 1998, which was a very good year for the company, Menard's five-percent bonus yielded him over $17 million. When added to his salary and profit-sharing, John Menard's total compensation for 1998 was over $20 million. The IRS didn't like this so much, viewing this as simply so far above what Mr. Menard was worth that it was unfair to allow the company to deduct it.

In 2004, the Tax Court agreed, concluding that only approximately $7 million of Menard's total compensation was "reasonable." The Tax Court treated the rest as a nondeductible dividend. In 2005, the Tax Court reconsidered, but upheld its own determination.

Give Me Shelter

The company Mr. Menard founded decided not to take "no" for an answer and went to the Seventh Circuit Court of Appeals. Notwithstanding the limited standard of appellate review, the Seventh Circuit ruled that the Tax Court had committed clear error in finding this compensation to be excessive. The Seventh Circuit, with the fierce intelligence of Judge Posner's sharp pen, skewered two aspects of the Tax Court decision: its discussion of the bonus repayment agreement, and its reference to the $7 million "reasonable" benchmark, which the Tax Court had geared to compensation paid to similarly situated CEOs of publicly held corporations in the same field.

Each of these areas of contention yields some neat benefits for those who walk in Mr. Menard's shoes. There is also a nice reference to the Tax Court's strange analysis that Mr. Menard needed no incentives to work hard, since his majority ownership yielded all the incentives he needed. That theory, said the Seventh Circuit, meant the Tax Court was internally inconsistent by ruling that $7.1 million in compensation was reasonable. Strange logic, quipped Judge Posner.

Savings Clause

I've long been a fan of provisions in agreements that recognize the importance of taxes. One sees such provisions in acquisition agreements; one sees them in settlement agreements resolving litigation; and one sees them in compensation agreements. I'm not sure who first thought of a provision in a compensation agreement stating that the recipient of the compensation would have to return any portion of the compensation that was later ruled to be nondeductible to the paying company. Whoever thought of it, it is a good and reasonable idea, at least from a tax-efficiency perspective.

Yet, should such a provision undercut the substance of the tax argument, looking like funny business that makes it less likely the payment will be deductible? That's a concern that's often raised about savings clauses. Despite the lip service that is often paid to this issue, in my experience, it is usually not a well-founded concern. Still, it is worth considering this canard.

Indeed, the IRS and the Tax Court both thought it pretty significant that the agreement between Mr. Menard and his company included such a provision. The IRS and the Tax Court reasoned that such a repayment provision simply made the payment look more like a dividend. Besides, said the Tax Court, a formulaic five percent of corporate earnings in a year simply *looks* more like a dividend than it does like salary.

The Seventh Circuit blew through such arguments as just plain "flimsy," noting the following:

- The five percent of net corporate income bonus did not look at all like a dividend.
- It was prudent for the company to require Mr. Menard to reimburse it should the IRS successfully challenge the deduction.

To the sometimes metaphysical question of what *looks* like a dividend, the Seventh Circuit said that dividends are generally specified dollar amounts, not a percentage of earnings. Plus, paying a fixed dividend gives shareholders more predictable cash flow where a dividend varies with fluctuating corporate earnings. The reason for tying a manager's compensation to company profits? Rather obviously, one does that to increase the manager's incentive to work hard to increase those profits. That reason has no application, said the Seventh Circuit, to a passive owner.

In fact, the Seventh Circuit went so far as to rebuke the IRS for questioning a compensation arrangement that had been in effect for decades, choosing to attack that arrangement in a year in which Mr. Menard had achieved outsize profits for the company, thus giving the IRS a great year in which to make its arguments. As to the savings clause, the Seventh Circuit did not have any difficulty at all in finding this to be simply a prudent way of doing business. Requiring the repayment was good for the company, and it was not good for Mr. Menard personally. Besides, such savings provisions are common.

Keeping up with the Joneses

The primary focus of the Tax Court in agreeing with the IRS was that Mr. Menard's compensation was excessively focused upon comparability. Just how much were comparable CEOs in 1998 getting paid? The CEOs of Home Depot and Lowe's were paid only $2.8 million (Home Depot) and $6.1 million (Lowe's), and those companies were larger than Menards.

At the IRS's urging, the Tax Court had arrived at what it thought was a reasonable figure of $7 million through using a formula. It would allow Menard to treat as reasonable compensation an amount of salary slightly more than twice the salary he supposedly would have earned had he been Home Depot's CEO, if Home Depot had enjoyed as high a return on investment as did Menards.

This sounds like investor rate-of-return analysis, of course. That was exactly the path the Tax Court took, viewing rates of return as driving CEO compensation. The Tax Court excepted out random factors that were assumed to have the same effect on Menard's compensation as they did on the compensation paid to Lowe's CEO.

The Tax Court was surely trying to do a good job in its economic analysis, but it got little credit from Judge Posner. He flatly labeled the Tax Court's machinations as "arbitrary as well as dizzying," particularly for disregarding the differences in the full compensation packages of the three executives it compared. Besides, said the Seventh Circuit, the Tax Court took no account of the different challenges faced by the companies, the different responsibilities of its CEOs, and their differing performance.

The Tax Court failed to compare the amount of work the three CEOs did in determining whether $7 million was reasonable compensation. (That does seem pretty fundamental.) The Seventh Circuit noted that Menard was a workaholic heading his own company, performing tasks that would have kept a whole team of people busy at a similarly situated company!

New Standards?

The Tax Court may surely feel cuffed about the head by the Seventh Circuit opinion in *Menard*. To my mind, Judge Posner was right. One can hardly evaluate the intensely factual and amorphous "how much is reasonable" question without looking closely at exactly who did what, over what period of time they were doing it, and with whom. There are probably half a dozen good reasons that the Seventh Circuit could have reversed the Tax Court on this one.

Although a closely held company's motives might well be questioned, the Seventh Circuit was certainly right that this arrangement had been in effect for many years. Indeed, the IRS seemed plainly to be cherry-picking a particularly outsize year and not doing so fairly. So after all the hubbub, will reasonable compensation standards now change?

Clearly, that's unclear. The Tax Court has generally applied a number of factors in assessing reasonableness. These include the employer's qualifications and contributions to the company, the employee's salary history, dividends paid, market standards, *etc.* If there's been some controversy about this, the Seventh Circuit had previously rejected the Tax Court's multifactor approach in favor of a single independent investor inquiry. [*See Exacto Spring*, CA-7, 99-2 USTC ¶50,964, 196 F3d 833.]

The independent investor test asks (in evaluating compensation paid) whether a hypothetical independent investor would consider the rate of return on his investment to be far higher than he had any reason to expect. If the hypothetical independent investor can clear that hurdle, the compensation paid is presumptively reasonable. Even then, such a presumption can be rebutted by evidence that the company's success was the result of extraneous factors (unexpected discovery of oil under the company's land, for example) as opposed to being a direct result of the employee whose compensation is being queried.

This kind of "independent investor" inquiry has also sprung up in cases in other circuits, including the Second and Ninth. And, it does seem like a reasonable line of inquiry, but it should clearly not be definitive. Indeed, it is fair to say that deciding whether compensation is reasonable usually involves a more amorphous facts and circumstances test that takes the entire mix into account. That is as it should be.

Last Word?

One of my favorite passages in Judge Posner's opinion in *Menard* is the notion that if the company had lost money in 1998, the founder's total take-home would have been only $157,500, even less than the salary of a federal judge! The Seventh Circuit noted that this would be the unfortunate economics, even if the company's loss had not been Mr. Menard's fault.

Although it is safe to say there is usually an incentive for a closely held company to pay deductible compensation rather than non-deductible dividends, the Seventh Circuit even took a swipe at these traditional incentives by noting that under the 2003 tax law changes, the tradeoff between dividends and salary became more complex. After all, the maximum tax rate for dividends is now lower than the maximum tax rate for salaries. As a poignant comment on tax incentives, the Seventh Circuit observed that under such rules, a company unable to deduct a $17.5 million bonus would have paid $6.1 million in additional income tax. Moreover, had Mr. Menard received such a bonus as a dividend and thus paid 15 percent (rather than 35 percent) in tax, he would have saved only $3.5 million. With current rates, it's simply not the tax bonanza the IRS attack seemed to suggest.

For most of us representing closely held businesses, *Menard* is a great case, restoring much of the confidence that most such taxpayers have in the validity of their compensation arrangements. There will still always be some concern when compensation appears to be outsize and where "disguised dividend" earmarks may be present. Yet in many (if not most) cases, the following mix of the totality of the circumstances will probably make everyone feel comfortable:

- Compensation arrangement and contract struck prospectively, not retroactively
- Compensation, even in outsize years, considered across the historical perspective that may include inadequate compensation in the past
- Comparative data about other similarly situated companies
- Comparative data about other similarly situated executives
- Personal effort expended, regardless of what other executives may do
- Dividend history
- Capital investment criteria for an independent investor

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