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Ten Things You Need to Know About 'Reasonable' Compensation

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What is reasonable compensation? Like jumbo shrimp, reasonable compensation may well sound like an oxymoron, at least when AIG and other bailed-out companies seem ever to reward executives with outsize bonuses.

With the considerable public outcry big pay packages are engendering these days, it is an opportune time to reflect on just how much compensation is reasonable, and why we care.

1. This Is About Tax Deductions

The historical roots of the reasonable compensation doctrine are not hard to fathom, despite current views about some notable Wall Street excesses. This is a tax concept, plain and simple.

In the context of closely held companies, there is a big dichotomy between the tax treatment of deductible compensation and the tax treatment of nondeductible dividends. It is therefore not surprising that many decades ago, cases started to emerge litigating the line between what is reasonable and what is not.

If the company cannot deduct the payment as reasonable compensation, it means it will be taxed to the company, and taxed again to the recipient. That means the government gets two tax slices, not just one.

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2. This Rarely Impacts Public Companies

At its root, you want compensation to be ''reasonable'' to avoid double tax, so the company paying the compensation can deduct it. These days most of the criticism is being leveled at public companies. Yet this issue is almost exclusively a problem with closely held companies.

A company can only deduct ''reasonable'' compensation. It cannot deduct unreasonable compensation and it cannot deduct dividends. In closely held companies, the payments are sometimes confused, and the tax incentives can be compelling.

With closely held companies, IRS has a keen eye for who is getting paid too much, since the assumption is that some of the money being paid out is probably a disguised dividend, paid as "compensation" so it will be deductible.

To be sure, public companies have their own set of rules about compensation, but at least they are less amorphous. For example, public companies are generally limited to deducting $1 million in compensation for any employee, except for certain ''performance-based'' compensation.

As you might guess from the size of many executive payouts these days, the performance-based exception has eaten up the rule. No one seems too concerned, since the Internal Revenue Service just does not see the same tax incentives in public companies.

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With closely held (especially family) companies, IRS has a keen eye for who is getting paid too much, since the assumption is that some of the money being paid out is probably a disguised dividend, paid as ''compensation'' so it will be deductible.

3. How Do You Prove Compensation Is Reasonable?

Taxpayers often end up in a defensive posture, trying to show that they were really worth the money, and that their closely held company ought to be allowed to deduct the payment. Yet a recent case from the Seventh Circuit Court of Appeals put IRS, and perhaps even the Tax Court, on the defensive on this issue.

The case is *Menard Inc. v. Commissioner* (7th Cir., No. 08-2125, 3/10/09), and it represents a big taxpayer victory.

Menard is the country's third largest home improvement chain, trailing only Home Depot and Lowe's in size. John Menard is the founder, controlling shareholder, and chief executive officer, receiving a base salary of $157,000. But since 1973, the Menards' patriarch has received an annual bonus equal to 5 percent of the corporation's net income before taxes.

In 1998, that formula yielded the patriarch $17 million, and IRS said that was unreasonable. To be accurate, John Menard's total compensation for 1998 was in excess of $20 million, including his salary and profit-sharing. IRS did not like this, and that was even before executive compensation was prompting today's ire.

IRS said this was far more than Mr. Menard was worth, so it was unfair to allow the company to deduct it.

The Tax Court agreed, but struck its own compromise figure, ruling that $7 million of it was reasonable. Menard licked his wounds after the Tax Court case and appealed to the Seventh Circuit.

4. Consider the Impact of Saving Clauses

Many compensation contracts now include a savings clause, requiring the employee to repay the company for any portion of his compensation that IRS disallows as ''unreasonable.'' Such a savings clause was present in the *Menard* case, and it was important.

A concern often raised is that a savings clause provision undercuts the substance of the tax argument, making it less likely the payment will be deductible.

I am 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 it 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. Such provisions are becoming more and more common across a wide range of situations.

Yet, does such a provision undercut the substance of the tax argument, making it less likely the payment will be deductible? That concern is often raised about savings clauses. The parties have said in advance that if there is a tax problem, they have allocated the burden of that tax problem.

Most business people would not think such a provision constitutes an admission that there is a tax problem, though some argue that it tends to flag the issue. Despite the lip service that is often paid to this canard, in my experience, it is usually not a well-founded concern.

Here, the Seventh Circuit did not have any difficulty in finding the savings clause to be a prudent way of doing business, and it did not import bad intent. Requiring the repayment was good for the company, and it was not good for Mr. Menard personally.

Besides, such savings provisions are common. IRS and the Tax Court in the *Menard* case both thought it significant (and implicitly suspicious) that the agreement between Mr. Menard and his company included such a provision. The Seventh Circuit disagreed.

5. Formulaic Bonuses Are OK

Formulaic bonuses are common, linking compensation to productivity. In *Menard*, the Tax Court thought a formulaic bonus of 5 percent of corporate earnings simply ''looked'' more like a dividend than like compensation. The Seventh Circuit blew through these arguments as just plain ''flimsy,'' noting that a bonus equal to 5 percent of net corporate income did not look anything like a dividend.

To the somewhat metaphysical question of what ''looks'' like a dividend, the Seventh Circuit said that dividends are generally specified dollar amounts, not a percentage of earnings. The 5 percent formula for Mr. Menard's bonus was therefore unlike most dividends. Plus, paying a fixed dividend gives shareholders more predictable cash flow where a dividend varies with fluctuating corporate earnings.

Why does one tie a manager's compensation to company profits? The court addressed that too. Rather obviously, one expressly ties compensation to profits 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 IRS for even questioning a compensation arrangement that had been in effect for decades. By choosing to attack this long-standing arrangement only in one year in which Mr. Menard had achieved outsize profits for the company, IRS was cherry-picking. Like a crouching tiger, IRS waited for a great year in which to make its arguments.

6. Consider Comparable Compensation

In any reasonable compensation case, how much competitors in the same industry, position, and geographic community get paid will be relevant. In fact, in the *Menard* case, the primary focus of the Tax Court (in agreeing with IRS that Mr. Menard's compensation was excessive) was the concept of 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

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(Lowe's), and those companies were larger than Menard's.

At IRS's urging, the Tax Court had arrived at what it thought was a reasonable figure of $7 million through using a formula that may well sound reasonable. 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, and that was assuming Home Depot enjoyed as high a return on investment as did Menard Inc.

This sounds like investor rate of return analysis, of course. That was exactly the position the Tax Court took, viewing rates of return as driving CEO compensation.

The Seventh Circuit was none too impressed with this analytical framework. In fact, Judge Richard Posner of the Seventh Circuit labeled the Tax Court's machinations ''arbitrary as well as dizzying,'' particularly for disregarding the differences in the full compensation packages of the three executives it compared.

7. Compare Apples to Apples

Comparability analysis must be thorough, and cannot simply assume any CEO does the same thing. It upset the Seventh Circuit in *Menard* that the Tax Court took no account of the different challenges faced by the companies, the different responsibilities of its CEOs, or their different performance.

How much work, how many tasks, how many reports, and how many balls in the air all had to be considered.

The Seventh Circuit castigated the Tax Court for failing even to compare apples to apples—the Tax Court had failed to compare the amount of work the three CEOs did in determining whether $7 million was reasonable compensation. That was fundamental. The Seventh Circuit noted that Mr. Menard was a workaholic, headed his own company, and routinely performed tasks that would have kept a whole team of people busy at a similarly situated company!

8. No One Factor Controls

A reasonable compensation case involves a multiplicity of factors. In fact, the Tax Court has generally applied numerous 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.

Under Exacto Spring's simplified test, to assess how reasonable compensation is, one asks whether a hypothetical independent investor would consider the rate of return on investment (with the compensation payment) to be far higher than he or she had any reason to expect.

In fact, perhaps trying to simplify this morass, the Seventh Circuit in a prior unrelated case—*Exacto Spring v. Commissioner* (7th Cir., No. 99- 1011, 11/16/99)—had previously rejected the Tax Court's multifactor approach in favor of a single independent investor inquiry.

Under this simplified test, to assess how reasonable compensation is, one asks whether a hypothetical independent investor would consider the rate of return on his or her investment (with the compensation payment) to be far higher than he or she 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 (such as unexpected discovery of oil under the company's land) rather than 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. It does seem like a reasonable line of inquiry, yet it should clearly not be definitive. Deciding whether compensation is reasonable usually involves a more amorphous facts-and-circumstances test that takes the entire mix into account. There is simply no litmus test.

9. Tax Incentives Can Change

There is usually an incentive for a closely held company to pay deductible compensation rather than nondeductible dividends. Nevertheless, the Seventh Circuit in *Menard* even took a swipe at these traditional incentives.

It noted that under our current rate structure, the trade-off between dividends and salary has become more complex. Today, the maximum tax rate for dividends is 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, the reasonable compensation versus dividend recharacterization dance is simply not the tax bonanza the IRS attack seemed to suggest.

It is unclear how much of the reasonable compensation debate going forward will focus on such issues. Yet it seems clear that many taxpayers will be emboldened by the *Menard* case.

10. Documentation Is Key

There will always be some concern when compensation appears to be outsize, and where ''disguised dividend'' earmarks may be present. Yet *Menard* is a great case, restoring much of the confidence many closely held businesses have in the validity of their compensation arrangements.

It is a taxpayer victory that is good for both companies and workers, with the kind of identity of interest that often permeates representing closely held businesses.

It also suggests a way forward in terms of dealing with a tax contest in this field. In many (if not most) cases, you can control much of the game with attention to documenting all of the following variables:

■ Strike your compensation arrangement (and document it in a binding contract) prospectively, not retroactively.

■ Consider total compensation across a historical perspective, which may include inadequate compensation in the past (do not just consider one year).

■ Gather comparative data about other similarly situated companies (and be specific and discriminating).

■ Gather comparative data about other similarly situated executives, what they do, how much they work, how many other roles they may fill, etc.

■ Consider personal effort expended, regardless of what other executives may do.

■ Consider dividend history, and be alert for ''disguised dividend'' arguments where no dividends are paid.

■ Consider capital investment criteria that an independent investor would consider if he or she were to invest in your company.

Finally, know that documenting all of this is key. Keep good records and be ready to produce a pile of paper if you have to.

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