Reasonable Compensation Lore in the Modern Era (Part I)

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To a person on the street, questioning whether compensation is reasonable is likely to sound puzzling. Yet to anyone with even a passing understanding of tax law, there is no confusion. The question is relevant for several reasons.

Classically, it is used for policing the line between deductible expenses and payments of nondeductible dividends. The topic today may seem antiquated, out of date with a system that pays little attention to seven- and eight-digit CEO packages. Can they be regarded as "reasonable" under most common understandings of the word? Perhaps not, yet they may be perfectly reasonable for tax purposes.

Historically, the vast majority of problems were with closely held companies. There, the dichotomy between deductible compensation and nondeductible dividends is clear. Then, in 1993, Internal Revenue Code Section ("Code Sec.") 162(m) was added to the tax law to provide a statutory fillip on reasonableness. Code Sec. 162(m) provides that publicly held corporations are not allowed deductions for employees' compensation in excess of $1 million. Notable among the exceptions is the rule that the cap applies only to covered employees. The class of covered employees generally includes the CEO and the persons who are the four most highly compensated officers of the company.

In the language of Code Sec. 162(m), the reasonableness factor is described as a remuneration that is performance-based. That means dependent upon the services rendered, and that sounds very much like reasonableness.

Modern Reasonableness?

In fact, performance-based compensation outside the scope of the Code Sec. 162 $1 million limit bears an uncanny resemblance to reasonableness. Code Sec. 162(m) excludes performance-based compensation from its $1 million cap. A compensation committee must establish performance goals. Also, the make-up of the compensation committee must satisfy certain requirements, including having two or more outside directors.

An outside director is someone who is (1) not presently an employee of the corporation or a related company; (2) not a former employee who still receives compensation for prior services (other than under a qualified pension plan); (3) not an officer of the corporation or related companies at any time; and (4) not currently receiving compensation from the corporation in any capacity other than as a director.

The compensation must be performance-based, and that means based on attaining one or more performance goals. Performance goals must be pre-established and in writing no later than 90 days after commencement of the services to which the performance goals relate. The outcome of any goal must be substantially uncertain when the committee establishes it.

Performance goals must be objective and must include performance standards applied to the individual employee, business unit or corporation. Performance goals must state the method for computing the compensation if the goals are met. Of course, stock options and stock appreciation rights are generally treated as performance-based compensation.

Most companies find that detailed performance goals generally make Code Sec. 162 and its cap not much of a threat. Unlike in the typical closely held company, full documentation becomes necessary if one is to avoid Code Sec. 162(m)'s limit. Indeed, its detailed hurdles make the deductibility of payments more secure.

Golden Parachutes, Too

In the M&A field, another compensation overlay that merits attention on virtually every deal checklist is the applicability of the golden parachute rules. Code Sec. 280G denies a corporation a deduction for any excess parachute payment. Code Sec. 4999 imposes a nondeductible 20-percent excise tax on the recipient. As with the $1 million compensation cap, reasonable compensation plays a part in the golden parachute rules.

Once one falls within the definition of a golden parachute payment to a disqualified individual, one asks if the payment was contingent on a change in the ownership or control of a corporation (or a substantial portion of its assets).

If so, one verifies whether the payment had a present value in excess of 300 percent of historic compensation. Yet even with all these ostensibly bad things, if you can prove that the payments were reasonable, then the dreaded excess golden parachute problem with its nondeductibility designation and excise tax wallop will not apply.

Like so much of the rest of reasonable compensation lore, whether payments to a disqualified individual are actually reasonable compensation for purposes of Code Sec. 280G will be determined on the basis of all facts and circumstances. [*See* Reg. §280G-1, Q&A-40.] Relevant factors include the nature of the services rendered, the disqualified person's historic compensation for those services, and the compensation of individuals performing comparable services in the absence of a change in ownership or control.

For past services, a showing that payments are reasonable under the standards of Code Sec. 162 will be treated as evidence they are reasonable compensation for purposes of Code Sec. 280G. [*See* Reg. §1.280G-1, Q&A-43.] For future services (to be rendered on or after the date of the change in control or ownership), clear and convincing evidence that the payments represent reasonable compensation will generally not exist if the disqualified individual does not in fact perform the services at that later date. [*See* Reg. §1.280G-1, Q&A-42(a).]

Independent Investor Test

One of the more objective factors focuses upon what an independent investor in the company would have expected and received. Some courts have determined that corporate profits (after deduction for salaries to shareholder-employees) should be considered in determining whether compensation paid is reasonable. One of the best-known cases is *Elliotts, Inc.*, CA-9, 86-2 USTC ¶9610, 716 F2d 1241 (1983).

There, the court stated that if the "company's earnings on equity remain at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and the profits are not being siphoned out of the company disguised as salary." [*Id.*, at 1247.] Applying the independent investor test is essentially a matter of considering the total return to the investor. One should include dividends, stock appreciation and corporate earnings.

That means there can be some flexibility. [*See Home Interiors & Gifts, Inc.*, 73 TC 1142, Dec. 36,842 (1980).] The IRS takes the position that a low rate of return on invested capital may support an inference that payments to shareholders constitute a distribution of profits. Of course, that is only an inference. The IRS has generally been required to show that this low rate of return during the years in question was caused by unreasonable compensation and not other factors such as fluctuating business cycles. [For example, *see Bringwald, Inc.*, CtCls, 64-2 USTC ¶9638, 334 F2d 639 (1964).]

[P]erformance-based compensation outside the scope of the Code Sec. 162 $1 million limit bears an uncanny resemblance to reasonableness.

In *LabelGraphics, Inc.*, CA-9, 2000-2 USTC ¶50,648, 221 F3d 1091 (2000), a corporation producing pressure-sensitive labels and selling to high-tech companies deducted $878,913 in compensation paid to the president and sole shareholder. The IRS disallowed $633,313. Defending the deductions, the company showed that the president was the heart of the company. He set corporate policy and monitored quality control, compliance and even external relationships. He also developed a new product.

The Tax Court upheld $406,000 of the $878,900 paid, concluding that the balance was not reasonable. The court was struck by the fact that the $722,900 paid to the President was nearly three times the amount of his largest prior bonus. Yet LabelGraphics failed to prove that any of this was attributable to prior inadequate compensation.

Regarding the independent investor standard, the Tax Court noted that given the large bonus, LabelGraphics suffered a loss, with a negative 6.19-percent return on equity. An independent investor would not be satisfied, the court said, especially when the bonus equaled 45 percent

of the investor's equity. The Ninth Circuit affirmed, finding that the Tax Court did not err in determining what was reasonable.

Documenting Your Way to Reasonableness

In closely held companies, documentation is often not what it should be. This is a shame since it can make such a difference. Plus, documentation done later is rarely as persuasive as it could have been if it is done contemporaneously.

As the case law proves, what is reasonable remains an intensely factual determination. One looks at the nature of the services rendered, the inadequacy of past compensation, the qualifications of the service provider, the compensation paid by other similar companies in the locality or in the industry, and other factors.

Intent

The intent of the payor is easy to overlook, but it remains relevant. An evidenced intent to compensate is useful in upholding treatment of compensation as reasonable. [*See Paula Constr. Co.*, 58 TC 1055, Dec. 31,555 (1972), *aff'd*, CA-5, 73-1 USTC ¶9283, 474 F2d 1345 (1973).]

Failure to Pay Dividends

The payment of dividends is the classic and traditional method of paying shareholders for corporate successes. As a result, the absence of any history of dividends tends to make compensation payments to shareholders suspect. Even so, the fact that a corporation has never paid dividends will not automatically result in asserted compensation payments being recharacterized as dividends. [*See* Rev. Rul. 79-8, 1979-1 CB 92.]

However, what about paying small dividends? Interestingly, the relevance of the payment of dividends is not necessarily tied to their amounts. The payment of small dividends, especially on a regular basis, can help to justify the deductibility of amounts paid as compensation. This is so even if the dividends paid over time are not large. On the other hand, some courts have used an independent investor standard. As described above, the question is whether an independent investor would have invested in stock that pays little or no dividends over time. [*See Elliotts, Inc., supra; Shaffstal Corp.*, DC-IN, 730 FSupp 1041 (1986); and *Webster Tool & Die, Inc.*, 51 TCM 86, Dec. 42,531(M), TC Memo. 1985-604 (1985).]

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