POINTS TO REMEMBER

When the Service Claims Compensation Is Unreasonable

By Robert W. Wood*

What is reasonable compensation? It may sound like an oxymoron, particularly when AIG and other bailed-out companies reward executives with outsize bonuses. With the public outcry over pay, it's an opportune time to ask how much compensation is reasonable, and why we care.

The reasonable compensation doctrine is a sticky tax concept. You want compensation to be "reasonable" to avoid double tax, so the company paying the compensation can deduct it. Although these days most of the criticism is being leveled at public companies, the tax issue is almost exclusively a problem with closely held companies. The company can deduct "reasonable" compensation, but not unreasonable compensation or dividends.

Often taxpayers end up in a defensive posture, trying to show they were really worth the money so their closely held company can deduct it. Yet a recent appellate decision put the Service, and perhaps even the Tax Court, on the defensive on this issue. The case is *Menard, Inc. v. Commissioner*, 560 F.3d 620 (7th Cir. 2009), and it represents a big taxpayer victory.

The Compensation Contract

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, its founder, controlling shareholder, and CEO, had a base salary of only $157,500.

Since 1973, the Menards patriarch has received an annual bonus equal to five percent of the corporation's net income before taxes. The compensation contract included a savings clause, requiring him to repay any portion of his compensation for which the Service disallows a deduction. This savings clause, it turns out, was pretty important, at least for 1998.

1998 was a very good year for the company, and yielded a $17.5 million bonus for the founder. When added to his salary and profit-sharing, his total compensation exceeded $20 million. The Service said this was so far beyond reasonable that it was unfair to allow the company to deduct it. In 2004, the Tax Court agreed, concluding that only about $7 million was "reasonable." The court treated the remainder as a non-deductible dividend. In 2005, the Tax Court reconsidered its determination, but upheld it.

Give Me Shelter

The corporation appealed to the Seventh Circuit. Notwithstanding the limited standard of appellate review, that court ruled that the Tax Court had committed clear error in finding this compensation to be excessive. Judge Posner's opinion skewered two aspects of the Tax Court decision: its savings clause analysis, and its formula for determining that $7.1 million was "reasonable."

There is also a nice reference to the Tax Court's strange comment 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. Each of these areas of contention yields benefits for those who walk in Mr. Menard's steel-toed shoes.

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, in settlement agreements resolving litigation, and in compensation agreements. Whoever first thought of a provision in a compensation agreement requiring the recipient to return any pay that was later ruled to be non-deductible, it is a good idea, at least from a tax efficiency perspective.

Yet, does such a provision undercut the substance of the tax argument, making it less likely the payment will be deductible? That's a concern 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 that constitutes an admission that there *is* a tax problem, though some will argue it helps to flag the issue.

Still, it is worth considering this canard, for the Service and the Tax Court in *Menard* both thought it significant that the compensation agreement included such a provision. The Service and the Tax Court felt such a clause made the payment look more like a dividend, as did a formulaic percentage of corporate earnings bonus. The Seventh Circuit called such arguments "flimsy."

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. Paying a fixed dividend gives shareholders more predictable cash flow than a dividend that varies with fluctuating corporate earnings. The formula for Mr. Menard's bonus was therefore *unlike* most dividends.

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Furthermore, companies tie compensation to profits to increase a manager's incentive to increase them. The Seventh Circuit went so far as to rebuke the Service for questioning a compensation arrangement that had been in effect for decades. By attacking a longstanding arrangement only in a year in which Mr. Menard had achieved outsize profits, the Service was cherry-picking.

As to the savings clause, the Seventh Circuit had no difficulty in finding it to be prudent for the company, and bad for Mr. Menard personally. Besides, such savings provisions are common.

Keeping Up with the Joneses

The Tax Court's primary focus in holding Mr. Menard's compensation excessive was comparability. How much were comparable CEOs paid in 1998? Other CEOs were paid only $2.8 million (Home Depot) and $6.1 million (Lowe's), and those companies were larger than Menards.

The Tax Court arrived at what it thought was a reasonable figure of $7.1 million by formula. It allowed Menard as reasonable compensation an amount slightly more than twice the salary he supposedly would have earned had he been Home Depot's CEO (had Home Depot enjoyed as high a return on investment as did Menards). The Tax Court viewed investor rate of return analysis as driving CEO compensation. It excepted out random factors, and came up with a number it felt was fair.

The Tax Court was surely trying to do a good job in its economic analysis, but it got little credit from Judge Posner. In fact, he 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. 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 different performance. One must compare apples to apples.

The Tax Court even failed to compare the amount of work the three CEOs did. Judge Posner noted that 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!

New Standards?

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, and with whom. There are probably half a dozen good reasons the Seventh Circuit could have reversed the Tax Court decision in *Menard*.

Although a closely held company's motives might well be questioned, the Seventh Circuit was right that this bonus arrangement was longstanding. The Service seemed plainly to be cherry-picking, and not doing so fairly. Taxpayers and their advisers should perk up from this case.

But after all the hubbub, will reasonable compensation standards now change?

The jury is still out, but *Menard* could be a bellwether case. The Tax Court has generally applied a number of factors in assessing reasonableness—the employee's qualifications and contributions to the company, the employee's salary history, dividends paid, market standards, etc. The Seventh Circuit previously rejected the Tax Court's multifactor approach in favor of a single independent investor inquiry. *See Exacto Spring v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

The independent investor test asks 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 its land, for example), as opposed to being directly attributable to the employee in question.

"Independent investor" inquiries have also been made in other circuits, including the Second and Ninth. Although it may be a reasonable line of inquiry, 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. That is as it should be. One of my favorite passages in Judge Posner's opinion in *Menard* is the notion that if the company had lost money in 1998 (even if it was not his fault), the founder's total take-home pay would have been only $157,500, less than the salary of a federal judge!

There are usually incentives for a closely held company to pay deductible compensation rather than non-deductible dividends. Nevertheless, the Seventh Circuit even took a swipe at these traditional incentives. It noted that under the 2003 tax law changes, the tradeoff between dividends and salary has become 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. Had Mr. Menard received such a bonus as a dividend and thus paid 15% (rather than 35%) in tax, he would have saved only $3.5 million. With current rates, the recharacterization dance is simply not the tax bonanza the Service attack seemed to suggest. It is unclear how much of the reasonable compensation debate going forward will focus on such issues.

Conclusion

For most of us representing closely held businesses, *Menard* is a great case, restoring much of the confidence that many such taxpayers have in the validity of their compensation arrangements. It is good for the companies and the workers, with the kind of identity of interest that often permeates representing closely held businesses. There will 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; and
- Capital investment criteria for an independent investor. ■