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Executive Compensation: When is Reasonable Compensation Unreasonable?

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EXECUTIVE COMPENSATION–WHEN IS REASONABLE COMPENSATION UNREASONABLE?

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In the short time allocated to the general topic of executive compensation, it is obviously impossible to cover all of its significant and troublesome aspects. In addition, it is dangerous to generalize as to the applicable principles to be followed in planning executive compensation in the small, closely held corporation. Terms such as "reasonableness" and "arm's-length transactions" predominate in the area and, of course, lead to a great deal of uncertainty and inability on the part of the tax advisor to predict with any degree of confidence the fate of an executive compensation program. The whole area of executive compensation might be best described by that old saying, "While the discreet take counsel, the fool doth his business." There is one saving factor, at least from the tax advisor's point of view–only successful clients cause worry about executive compensation problems. I am sure that there is no one here today who would trade his stable of successful clients for the luxury of not having to worry about such matters.

I have selected for discussion two areas related to the deductibility of executive compensation. First, I will briefly examine the statutory and regulatory standards applied in determining such deductibility, particularly in light of two significant cases. Second, I shall turn to an analysis of deductibility problems and attempt to articulate the precautions that can be taken to protect against disallowance. My talk might appropriately be labeled, *When is Reasonable Compensation Unreasonable?*

Section 162(a)(1) of the Code permits a deduction for ordinary and necessary business expenses, including a deduction in the form of a "reasonable allowance for salaries or other compensation for personal services actually rendered." The regulations[1] provide that the "test of deductibility in the case of compensation payments is whether they are reasonable *and* are in fact payments purely for services." Thus, it is clear that there are two aspects that must be considered before a deduction will be permitted, namely, whether the dollar amount paid was "reasonable" in terms of the *value* of personal services rendered and whether the payments were in fact only for such personal services.

In most cases the sole focus of judicial inquiry has been directed to an independent examination of the "value" of services rendered by the employee.[2] If the court concluded that the true value of the services rendered was below that actually paid, the excess was viewed as payment for some other purpose, usually as a distribution of profits.[3] This approach to the

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[1]Regs. § 1.162-7(a).

[2]See cases collected in No. 202-2nd, Tax Management Portfolio, "Reasonable Compensation" (1971).

[3]It is possible, however, that the alleged compensation payments could be viewed as payment for property. *See* Regs. § 1.162-7(b)(1) wherein an example of such treatment is set forth involving the sale of partnership assets to a corporation and subsequent payments to the former partners, alleged to be salary payments, but in fact constituting payment for the transfer of assets to the corporation.

problem is contemplated also by the regulations which illustrate the test of deductibility involving a small, closely-held corporation by saying, "If. . .the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock."[4]

Thus, the second aspect of the test (the "purpose" of payments) was not viewed as an independent criterion, but rather merely as a conclusion once the court determined that the payments were "excessive" in terms of the value of services actually rendered.

In planning and defending executive compensation programs we, as tax advisors, have tended to become preoccupied with factors such as the salary history of the individual,[5] the salary situation in comparable businesses,[6] the degree of individual contribution to the success of the business,[7] and the expertise of the individual,[8] factors which all go to prove the issue of the "reasonableness" of compensation. It was assumed, and with good reason, that if personal services were in fact rendered and if what was paid was "reasonable," there could follow but one conclusion–the deduction should be allowed in full.

The validity of that assumption, however, is undermined by at least two cases, one of fairly recent origin and the other not so recent. I am sure the cases I refer to are familiar to you, so I will only briefly refresh your recollection of the facts and proceed to analyze what those cases should say to us in terms of planning an executive compensation program.

Taking the cases up in reverse chronological order. I will discuss first *Charles McCandless Tile Service v. United States*.[9] The *McCandless* case involved the issue of the reasonableness of salaries paid to two officer-director-shareholders, father and son. Although the facts are somewhat unclear, it appeared that, in the three-year period during which the salaries paid were in question, the two owned equally all or substantially all of the outstanding stock of the corporation. Not surprisingly, the amount paid to each was equal. It was clear, however, that from a corporate viewpoint the two determined the amount of compensation paid to themselves. The corporation was highly profitable and, according to the court, the individual officer-shareholders whose salaries were questioned were "largely responsible" for the corporation's success. The court considered the compensation paid to the two "in and of itself to have been within the realm of reasonableness" based largely

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[4]Regs. § 1.162-7(b)(1).

[5]*See, e.g.,* Pacific Grains, Inc., 36 T.C. Memo 67, 399 F.

[6]*See, e.g.,* Jones Bros. Bakery, Inc. v. U. S., 411 F.2d 1282 (Ct. Cl., 1969).

[7]*See, e.g.,* Appleton Electric Co., 36 T.C. Memo 1144 (1967).

[8]*See, e.g.,* Superior Pattern & Mfg. Co., 28 T.C. Memo 299 (1959).

[9]422 F.2d 1336, 25 AFTR 2d 870 (Ct. Cl., 1970).

on the degree of success enjoyed by the business. Nevertheless, the court went on to conclude that a portion of the payments should be disallowed. The decision was based on that part of the previously mentioned regulations which require that, to be deductible, the payments must be "purely for services" actually rendered. The court, noting the complete absence of any dividends paid during the period, concluded that "any return on equity capital is so conspicuous by its absence as to indicate. . .that the purported payments necessarily contained a distribution of corporate earnings within." In a footnote to the opinion, the court acknowledged that the retention in the corporation of one-half of pretax profits (the other half being paid as salaries) was apparently motivated by conservative business policies, that is, to build up operating capital reserves. The court, however, also noted that only a small portion of such reserves were in fact utilized for such purposes. You all know the scenario—the court arbitrarily concluded that, in a corporation of this nature, a "reasonable" return to the shareholders would be 15 percent of profits before salaries and taxes and accordingly disallowed as a deduction a portion of the purported compensation payments equal to such figure. By way of secondary interest, we might all wonder why the court used a percentage of profits rather than investment as the basis for determining a reasonable return to the shareholders.

In my opinion the decision of the Court of Claims in the *McCandless* case was fundamentally correct even though the court's factual analysis and justification for the decision leave something to be desired. The case does, however, emphasize certain salient factors to be considered by the tax advisor in planning an executive compensation program, factors which have been overlooked in the past.

The fundamental principle to be taken from the *McCandless* case is that an evaluation of the sanctity of an executive compensation program cannot be made in a vacuum, that is, by focusing solely on the dollar level of payments to the exclusion of other equally important factors. We are, after all, dealing with a corporation. In a corporation there are three primary demands placed on gross earnings:

1. the need to meet ordinary and necessary business expenses, including most importantly for our purposes, compensation of the executives;
2. the need to retain some money in the corporation to meet operating and capital expenditure needs; and
3. the need to compensate those who have taken the investment risk—the shareholders.

Our present tax structure treats each of these needs differently. For example, it permits a deduction for executive compensation in arriving at net taxable income, but it does not permit a deduction for dividends paid to shareholders. It does not penalize with a surtax a corporation paying dividends, but does penalize an unjustifiable accumulation of net earnings above a certain amount. In the contemplated corporate model, the officers who must be compensated, the directors who fix such compensation and determine dividend levels, and the shareholders who expect a return on their investment, are not one in the same person and we might say, have adverse interests. With such a model the system works well in that we can assume that the decisions that are made in meeting the three demands placed on gross earnings are not motivated wholly by tax considerations. In the case of a small, closely-held corporation with its identity of management and ownership, it is impossible to say from an economic standpoint that the demands on corporate earnings, at least as between executive compensation and shareholder return, are influenced by independent market factors. The short and simple truth is that such demands are usually influenced by tax considerations. Thus, the Court of Claims was focusing on the basic issue when it concluded that, even though the dollar level of executive compensation was reasonable, the taxpayer's justification for its treatment of the two other competitive demands on corporate gross earnings was lacking. The court was saying, in effect, that in a real-life situation when you pay 50 percent of net earnings, before deducting salaries and taxes, to reasonably compensate your executives, absent a compelling demand to retain the remaining earnings in the corporation for operating capital, market factors would dictate that the shareholders, as an entity, would realize a substantial return on their investment. Since in the *McCandless* model, no dividends were paid and there was no showing of a need to retain earnings in the corporation, the court could only conclude that part of the payments to the officer-shareholders was a disguised dividend. A contrary result would have been intellectually dishonest. The "purpose" of the payments, viewed from an "objective" point of view, that is, a corporation influenced by traditional competitive demands on its gross earnings, was not wholly to compensate the officers for personal services. It was for some other purpose, namely, to compensate them in their capacity as shareholders. Thus, the second part of the statutory and regulatory tests was not met.

I do not mean to imply that the foregoing analysis of the Code, Regulations and the *McCandless* case make traditional concerns in planning executive compensation programs invalid or that the Service will no longer challenge executive compensation in a particular case as being clearly excessive in terms of the true dollar value of services rendered. Instead, I am merely saying that in addition to laying the foundation to support the dollar level of compensation, we must also be concerned with analyzing and laying the proper foundation to justify our treatment of the other two competing demands on corporate gross earnings. Have we adequately compensated the shareholders as contemplated by the traditional corporate model and the tax structure? That inquiry requires consideration of the need and justification for our decision to retain or not to retain a portion of earnings in the corporation for other needs.

It has been said that the *McCandless* case stands for the proposition that the courts may be moving toward the adoption of an "automatic dividend" rule.[10] In my opinion no such result is inherent in the decision. *McCandless*

[10] 32 Journal of Taxation 331 (1970).

does, however, emphasize the importance of a close analysis of the total earnings picture of a corporation in terms of its relevance to a sound determination of the reasonableness of executive compensation. Such an analysis of the *McCandless* case calls for one additional observation. Even though the case involved a complete absence of dividends, it would not be a big step for a court to say that a conservative dividend policy, in a situation such as the *McCandless* case, was so unreasonable in light of the total earnings picture as to mandate a reconstruction of distributions to employee-shareholders.

The second case that I wish to discuss is *Klamath Medical Service Bureau v. Commissioner*, a 1958 Tax Court case subsequently affirmed by the Ninth Circuit.[11] The *Klamath* case involved a medical service corporation engaged in the business of selling prepaid medical, surgical and hospital contracts. All of the shareholders were local physicians who entered into agreements with the taxpayer to perform medical services for contract holders according to a fee schedule fixed by the taxpayer. The taxpayer's principle source of income consisted of premiums paid by subscribers, but additional income was derived from noncontract patients who used its hospital facilities. The physician-shareholder's contracts with the taxpayer provided that each physician would receive for services rendered a percentage of his base fees, as determined by the fee schedule, equal to the percentage of the taxpayer's net income contributed by each physician, less a proportionate amount retained for corporate purposes. During the early years of operation, the physicians received less than 100 percent of their billings. However, in the three years in question, the physicians received 115, 116 and 134 percent of their billings.

The Tax Court, in limiting the deduction to 100 percent of gross billings of each physician, appeared to adopt a rather quixotic position concerning the "reasonableness" of the salaries. It noted that the fee schedule was unreasonably low when compared to like services provided by physicians engaged in private practice but, nevertheless, was equitible and fair when the lessened costs provided by the taxpayer were considered. It was clear, however, that the Tax Court did not consider the "reasonableness" of the payments made to the physicians as dispositive of the issue, since the court correctly noted that unless the full amount paid was compensation for services and not a partial distribution of earnings, a deduction for the full amount was properly denied by the Service. The basis of the court's conclusion that the excess amount paid over 100 percent amounted to a distribution of earnings was that each physician had, in advance, agreed to accept the taxpayer's payments, in accordance with the fee schedule, in full payment for services rendered, regardless of the fact that such might be less than "reasonable." Contractually, the taxpayer had fully discharged its obligation to its shareholder-employees, in accordance with its previously

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[11] 29 T.C. 339, aff'd. 261 F.2d 842 (9th Cir., 1958).

fixed obligation, when it paid out 100 percent of the billings submitted by such persons. Payments in excess of 100 percent of billings, said the court, were not "authorized" by the employment contracts.

There was, of course, additional evidence that the taxpayer "intended" a portion of the payments to be a distribution of earnings. For example, testimony of one of the directors of the taxpayer was to the effect that the total amount paid to the physicians was a year-end decision arrived at after considering future corporate needs for operation and expansion, the excess being distributed to the physicians. Thus, much of the *McCandless* case analysis is also applicable to the situation presented in *Klamath*.

However, I believe the *Klamath* case is more important for its implicitness about the relevance of the contractual or previously fixed obligation to compensate employees. Charles Finley may tear up the contract of Vida Blue in mid-season or pay a substantial bonus to Gene Tenance after the World Series without regard to the earnings of the Oakland Athletics, but corporations with normal management personnel who respect the expectations of shareholders do not "bonus-out" earnings at year-end.

The dilemma is obvious. In terms of evidencing the reasonableness of compensation, although the absence of a previously negotiated contract is not fatal,[12] nor is it fatal that compensation is fixed retrospectively or is in excess of that previously fixed,[13] the desirability of an advance, formal, fixed obligation to pay is clear, especially when there are two or more owner-employees who negotiate on an arm's-length basis. However, the existence of such a previously fixed contractual obligation to pay, when the issue at stake is whether the payments were in fact compensation for services rendered, should be viewed by the courts as a neutral factor. Whether the amount paid was "reasonable" is, of course, a different question and with respect to that issue, the existence of a previously fixed obligation should be viewed as highly persuasive in support of the deductibility of the amount in full. The fixing of the obligation in advance is genuinely influenced by factors other than tax considerations, the most obvious one being the credit standing of the taxpayer.

However neutral the existence of the fixed obligation to pay is with respect to proving that the whole amount paid was in fact for services actually rendered, once the obligation is created, a mid-stream or year-end variance from the figure should be viewed as extremely probative in indicating that payment was not in fact for such services.

I certainly do not mean to imply that year-end bonuses are per se nondeductible. Given the right set of circumstances and full consideration of factors discussed in connection with the *McCandless* decision, a bonus may

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[12] E. B. & A. C. Whiting Co., 10 T.C. 102 (1948).

[13] I. R. Schmalls Co., Inc. v. U. S., 406 F.2d 1044 (7th Cir., 1969).

be perfectly acceptable. For example, when the fixed obligation is *clearly* below that which otherwise would have been reasonable in light of the year-end profit picture, the payment of a bonus should be easy to support if, when added to annual compensation previously paid, it would still permit adequate treatment of the other competing demands on corporate gross earnings. The principal lesson to be taken from the *Klamath* case is that we must emphasize to the client that the figure fixed in advance, be it set or contingent, must be considered carefully before being immortalized in writing and not be one which carries with it the presumption of being "renegotiable" freely at year-end when the profit picture is known and greater than expected. In terms of the statutory and regulatory tests, the excess payments could easily be viewed as for some other purpose, since the contractual obligation was fulfilled by payment of a lower figure. As the Court of Appeals said in affirming the Tax Court decision in the *Klamath* case, the increased payments may have been "ordinary" in the sense that they were "reasonable," but they were clearly not "necessary" in the sense that the contractual obligation of the corporation was clearly satisfied by the payment of a lesser amount.[14]

[14] 261 F.2d at 848.