"Reasonable Compensation," Deductability for Income Tax Purposes: Three Case Studies

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"REASONABLE COMPENSATION," DEDUCTIBILITY FOR INCOME TAX PURPOSES: THREE CASE STUDIES

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This article is written for the general practitioner. The rules determining deductibility for federal income tax purposes of compensation paid to corporate officers are old hat to the tax specialist. He will have played the reasonable compensation game more than once. So while we welcome our tax friend to remain—perhaps he will find here a fresh approach for his next case—the real purpose of the article is to reach the non-tax lawyer; to breed for him, through case study, instant familiarity with what is known as "reasonable compensation."

Three cases will be considered. The taxpayers involved are not imaginary. Their respective stories stem from hard facts, although some slight liberty has been taken to better illustrate this game of IRS: "It is not reasonable compensation" vs. Taxpayer: "It is too reasonable compensation."

The cases will be developed in an effort to give the general practitioner a "feel" for the handling of a typical reasonable compensation tax case. Specific facts and figures will take a back seat to general approach and practical technique. Hopefully, the general practitioner will learn from these studies that this is one area of the tax field which he can enter without fear and trembling. For, as will be seen, what constitutes reasonable compensation for tax purposes boils down to a simple question of fact. In making this factual determination and presenting it on behalf of his taxpayer client, the lawyer will be using the same skills he has developed in other areas of the law.

THE PROBLEM

What does "reasonable compensation" mean? If a concern pays a specified salary to an officer, what business is it of the Internal Revenue Service what that salary is? The answer is simple enough. The taxpayer

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1. Discussion herein is limited to the United States income tax (Int. Rev. Code of 1954, Subtitle A (§§ 1-1561)).
is allowed to deduct for federal income tax purposes all ordinary and necessary expenses of the business, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." So, it is perfectly legitimate business for the Revenue Service to know what the officer's salary is; if the taxpayer wants to deduct that salary as an allowable expense, it must be reasonable. And this is where the problem arises: What is "reasonable?" Other questions as to deductibility of a particular salary might arise. For example, does it represent compensation for service actually rendered? What constitutes "compensation?" Has the salary actually been paid or incurred? But the real problem, one which underlies most of the controversies regarding deduction for compensation, involves the "reasonableness" of the amount paid.

The problem may be narrowed for purposes of this article to reasonableness of compensation paid to officers of closely-held corporations. As a practical matter, a revenue agent auditing the return of a publicly-held corporation will rarely question the deduction for salaries. And he will be justified in doing so, for if the directors and stockholders, dealing objectively and at arm's length with the officers, have fixed the salaries in amounts determined to be proportionate to their worth, there is neither need nor reason for the agent to make any change.

So, the problem relates to the closely-held corporation. In its simplest form, we are concerned with a small corporation owned by one person, paying that person a substantial salary, and enjoying substantial earnings. A decision must be made as to whether the total salary is reasonable and therefore properly deductible, or some portion excessive as an attempt to distribute earnings, and not allowable as a deduction.

**Rules of the Game**

To resolve whether the salary is reasonable, one must know the rules

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2. **Int. Rev. Code** of 1954, § 162 (a) (1). A taxpayer is not entitled to deduct salary paid to himself, unless he also reports the same amount as income. *Est. of Nottingham*, 15 *CCH* Tax Cr. Mem. 1454 (1956).


of the reasonable compensation game. These rules—the factors to be considered in determining reasonableness—are well established and simple enough to learn. The difficulty lies in applying them to the factual situation.

So, although it may be said generally that reasonable compensation is that which would ordinarily be paid for like services by like enterprises under like circumstances, each case bears its own peculiar set of facts, and these will govern as to whether the subject compensation is reasonable.

The courts have developed guidelines to aid in determining reasonableness, including: the type and extent of services rendered by the employee; the scarcity of qualified employees for the particular position; the qualifications and prior earning capacity of the employee; the contributions of the employee to the business venture; the compensation policy of taxpayer; the volume and amount of the taxpayer's net earnings; the location and character of the taxpayer's business, including its special or peculiar characteristics, if any; the ratio of the particular compensation and aggregate compensation to the taxpayer's gross income; the prevailing compensation paid to employees performing similar services in other comparable enterprises; and the general economic conditions.

The test of reasonableness applies on an individual basis, and not collectively. Therefore, an officer-owner of a corporation who pays himself an excessive salary will not be able to justify it on the basis that the overall compensation paid to other officers is reasonable. The courts and the Service will look at each individual case. The fact that there is on record a formal resolution by the board of directors approving the salaries specified will be taken into consideration.

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7. Builders Steel Co., 8 CCH Tax Ct. Mem. 296 (1949), rev'd on other grounds, 179 F.2d 377 (8th Cir. 1950); Treas. Reg. § 1.162-7(b)(3) (1958) ("The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned."

8. "... [F]acts and circumstances vary so widely that each corporate tub must more or less stand upon its own bottom." Miller Mfg. Co. v. Commissioner, 149 F.2d 421, 423 (4th Cir. 1945).

9. 4A Vertens, Federal Income Taxation § 25.69 (J. Riordan rev. 1966) and cases therein cited.


11. Robert Louis Stevenson Apartments, Inc. v. Commissioner, 337 F.2d 681 (8th Cir. 1964); Brown-Forman Distillers Corp. v. United States, 132 F.Supp. 711 (Ct. Cl. 1955). In the reasonable compensation field, as in other areas of law, the courts are
ever, in a closely-held corporation, the taxpayer may find little weight being given to the corporate minutes approving the salary subject to question. And, of course, particularly suspect in each reasonable compensation case will be a bonus paid at the end of the year. These usually have little precedent and are based upon profits for the year. It will not be difficult to recognize such as a disguised dividend.

Perhaps the most important rule for the taxpayer and his attorney to remember is the presumption of correctness attaching to the Government's position. Once the examining revenue agent determines that a particular salary is excessive, it is up to the taxpayer to reverse or modify that determination. Whether it is during the appellate process within the Revenue Service itself or at trial before court or jury, the taxpayer must prove himself "innocent" by overcoming the presumption that the agent's determination is correct. So, this rule must be grasped from the very beginning: to prevail, the taxpayer must carry the burden.

APPLICATION OF THE RULES BY CASE STUDY

To illustrate how the rules of reasonable compensation are applied, three cases will be examined. The preliminary backgrounds of each of the three taxpayers leading to the issue of reasonable compensation will be traced. There will follow a discussion of the administrative processing of the issue, the taxpayer's rights of appeal and the rule of the case.

reluctant to substitute their judgment for that of the directors who are, presumably, familiar with the amount and value of services rendered. Indialantic, Inc. v. Commissioner, 216 F.2d 203 (6th Cir. 1954).


14. The general presumption that the assessment of tax deficiency made by the Commissioner of Internal Revenue is prima facie correct (see cases collected at 6 CCH 1968 STAND. FED. TAX REP. ¶ 5781.56), applies with equal force to reasonable compensation cases. See, e.g., Roth Office Equipment Co. v. Gallagher, 172 F.2d 452 (6th Cir. 1949).

15. It has been stated that:

[Although the taxpayer is said to have the burden of proof in these cases, it is more accurately described as the burden of proceeding with the proof. There is a presumption that the Commissioner's determination as to the proper amount of compensation which is deductible is correct. If the taxpayer does not counter with acceptable testimony or other evidence, he fails to meet the burden which has been thrown upon him, and the decision is necessarily in favor of the Commissioner.

1 CCH 1968 STAND. FED. TAX REP. ¶ 1372.012.
Preliminary Background

(A) Case No. 1: Trans Porter, Inc. The story of Trans Porter\textsuperscript{16} is an indication of the success obtainable by an individual combining native ability with a willingness to work. Trans was born of a family with little means and hence had no opportunity to complete his formal education. Leaving school at an early date, Trans went into the trucking business. Initially, he drove a rig for a national concern. Subsequently, he was able to save sufficient capital to buy his own rig, and from that modest beginning expanded his operation into a transportation facility with a hundred tractor-trailers. Early in his career he established a relationship with the president of a manufacturing concern, Big Op Corp. This manufacturer had used various trucking companies to haul its products. The arrangement was not satisfactory, and Big Op determined that it needed its own transportation department. At this point, Big Op entered into a lease with Trans Porter, who had by then incorporated as “Trans Porter, Inc.,” for all of the tractor-trailer equipment of Trans Porter, Inc. The manufacturer would operate and employ the drivers of the rigs thus leased, but with Trans still responsible for all service maintenance.

The arrangement proved to be successful from the very beginning. Trans worked closely with the officials of Big Op, integrating the transportation with an awareness of the manufacturing problems. Big Op’s growth into one of the largest concerns in the industry was related in major part to its excellent transportation arm. And, of course, as the manufacturer grew, so did its need for additional trucks to be leased, and as these rentals increased, Trans Porter, Inc., enjoyed high revenues.

It was precisely at this moment that the revenue agent entered the picture. He took a first look at the fact that Trans Porter, Inc., was solely-owned and a second look at the salary paid to Trans. He then determined to disallow a substantial portion of the salary as “unreasonable” compensation.

(B) Case No. 2: Sales Co. Just as Big Op Corp. in the first case study decided that it would be in its best interest to have its own transportation arm, so did manufacturer, Plant Co., in the second case decide that it would have its own sales agent. It entered into an agreement with the taxpayer, Sales Co., designating Sales Co. to serve as exclusive

\textsuperscript{16} While each case is based on a factual situation, the names have been changed to protect the real parties in interest.
sales agent for Plant Co. and establishing a specified commission arrangement.

This proved to be a wise move, as within a span of a few years, Sales Co. more than tripled the sales volume of Plant Co. products. The results were due primarily to the efforts of the principal officers of Sales Co.

As commissions from Plant Co. rose, Sales Co. increased its compensation to its principal officers in accordance with a formula established in a previous year by Sales Co.'s board of directors. It was at this point that the Revenue Service conducted an audit, and the challenge issued as to the reasonableness of the compensation.

(C) Case No. 3: Better Mousetrap, Inc. Two brothers, the Capables, succeeded in taking a small operation manufacturing machinery and expanding it into a sizeable business. Their product was unique. They had examined carefully the problems encountered by customers in their industry and had designed a machine to meet these problems. The combination of their inventive genius with long, hard work in manufacturing and marketing the product led to success of their company, Better Mousetrap, Inc.

At the height of the company’s success, the two brothers decided to sell the assets to National Concern. As part of the same transaction, each brother was retained for further service to the acquiring concern. One was retained as consultant at a salary half that paid to him prior to sale, but with his being required to spend only one-half of his time as a consultant. The other entered into an employment agreement also calling for reduced salary, but with the express provision for him to devote himself to other matters. Once again the Revenue Service conducted an audit and determined that the compensation was excessive and therefore not deductible.

Administrative Process and Taxpayer’s Rights of Appeal

We have before us the three factual situations: Trans Porter, Inc., leasing its trucks to a large manufacturer; Sales Co., serving as exclusive sales agency for another large manufacturer; and Better Mousetrap, Inc., the somewhat smaller but just as successful machine manufacturer, whose assets were subsequently sold to a national concern. In each case, the reasonable compensation issue was disposed of to the satisfaction of the taxpayer by settlement during the course of the Internal Revenue Service appellate process. The factors which went into settle-
ment will be considered in a moment, but it is appropriate to pause at this juncture to review the administrative handling of a reasonable compensation case and what rights of appeal exist.

A. Stage 1—Revenue Agent. Of course, the issue initially arises upon audit by the examining revenue agent. His audit may be routine, as in the case of Trans Porter, Inc. and Sales Co., or the audit may have resulted because of a special event, such as the sale of Better Mousetrap, Inc., to the national concern. In any event, the agent makes his audit and discusses his proposed adjustment of salary with the officers of the taxpayer corporation. Generally, the taxpayer’s accountant is involved at this step, but not necessarily so. Usually there is little opportunity to resolve the matter at this stage. Once the agent has made his investigation, applied to the facts, as he sees them, the rules governing reasonable compensation, it is difficult to persuade him to vary substantially from the adjustment he proposes. By and large, settlement at the agent’s level can be disregarded as a real likelihood.17

B. Stage 2—Conference Staff. The agent makes his report, leaving unresolved the question as to reasonableness of compensation. As a result, there will be issued to the taxpayer a form letter from the District Director, noting the agent’s proposal and including his report, and giving the taxpayer an opportunity to appeal, or to put it more technically, to “protest” the adjustment proposed. The form letter will enclose an attachment setting forth the taxpayer’s rights on appeal,18 including his right to file a formal notice of protest and to have a conference. The taxpayer is told that he can avail himself of the first appellate level, the Conference Staff of the District Director’s Office, or he can bypass the Conference and go directly to the Appellate Division of the Regional Commissioner’s Office.19

Unlike the situation at the agent’s level, the opportunity for dispo-

17. We are discussing here the situation where the agent has completed his audit and determined that substantial adjustment must be made in compensation allowable. It should be made clear, however, that every day, audits are made where the question of reasonableness is not raised, or if it is raised, only a minor adjustment is required to bring the salary to a "reasonable" level.

18. These rights are set forth in Revenue Service’s Statement of Procedural Rules, Treas. Reg. § 601.105(c) and (d) (1968).

19. “If the issues involved are such that there appears to be little possibility of disposing of them in a district Audit Division conference, the taxpayer will be encouraged to bypass the district conference in favor of prompt consideration of his case by the regional Appellate Division.” Treas. Reg. § 601.105 (c) (2) (iv) (1968).
sition at the Conference Staff is substantial. As a matter of fact, it is fair to say that in a normal case, where a reasonable taxpayer is dealing with a reasonable conferee, disposition of the compensation issue should be made at the Conference Staff level. This is true for several reasons. In the first place, the reasonable compensation issue is the type of issue readily subject to settlement by a member of the Conference Staff. He has sufficient authority to make the factual determination as to reasonableness, although his authority is less than that of the next stage, Appellate Division, to the extent that generally he is not authorized to settle on the basis of "hazards of litigation." But if the conferee is fully informed on the facts of the particular case, and applies the rules of reasonable compensation to those facts in an equitable manner, there is absolutely no reason why settlement should not be had with him. In the second place, it is to the taxpayer's advantage to resolve the compensation issue at the very earliest opportunity. Each step in the appellate process is more expensive and time consuming. Hence, if favorable disposition can be made at the early Conference level, this is the time to do so.

C. Stage 3—Appellate Division. If, for whatever reason, the taxpayer and the member of the Conference Staff have not been able to get together as to a salary which each considers to be reasonable under the circumstances, the taxpayer next is entitled to appeal to the Appellate Division of the Regional Commissioner's Office. It should be noted at the outset that the Appellate Division is associated with the Regional Commissioner's Office rather than the District Director's Office, to which the Conference Staff is associated. This should be all the more

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20. Sifting out and resolving facts is the real forte of the district conferee. And because resolution of a reasonable compensation case boils down to what are the facts in that particular case, the conferee is particularly well equipped to handle this kind of issue.

21. The general practitioner must be careful to advise his client that any settlement made with the conferee is subject to review within the conferee's office. This caveat applies also to the Revenue Agent and Appellate Division stages. It is a rare case when the conferee's recommendation is not approved, but it can happen and taxpayer should be so advised.

22. In some Internal Revenue districts, the member of the Conference Staff assigned to taxpayer's case will meet with the taxpayer and the representative at the Service's branch office where taxpayer lives, saving the taxpayer substantial time and the expense of travel. In Virginia, the Conference Staff is known for its cooperation in arranging conferences at times and places convenient to taxpayer and its representative.

23. The officer in charge of the Appellate Division has final settlement authority in cases in which a taxpayer has protested the District Director's determination. Treas. Reg. § 601.106(a) (1968).
reason for objective study and review by the appellate conferee of the adjustments proposed below. 

The appellate conferee has the same authority to settle as does the member of the Conference Staff, plus additional authority, including that of disposition on the percentage chances of the Government's finally prevailing. In cases involving other issues, this authority to settle on the basis of "hazards of litigation" can be quite helpful to taxpayer and Government alike. However, in the reasonable compensation area, it should not be as important a factor, the emphasis here still being a factual determination as to what salary is reasonable under all the circumstances.24

D. Stage 4—Judicial Determination. When all is said and done, if taxpayer and the Government have not resolved on a mutually agreeable basis the reasonableness of the salary through the three stages of the agent, conference, and Appellate Division, then the ultimate determination will have to be made on the judicial level. Whether the taxpayer elects the Tax Court, the United States District Court, or the Court of Claims is going to depend upon all the factors in the case. It may be that the corporation cannot afford to pay the tax which would result from the proposed disallowance of compensation. If so, the only choice is to go to the Tax Court.25 If the taxpayer can make payment and thereafter file claim and suit for refund, it may be to his advantage to have the case tried before a favorable judge or jury in its own community.26

While it is beyond the scope of this article to mention all the factors involved in selection of the particular forum to test the compensation, it is appropriate to comment on two important factors. The first relates to evidence. Several courts hold that unrefuted expert testimony presented by the taxpayer as to reasonableness is sufficient alone to overcome the presumption of correctness attaching to assessment,27 while

24. Taking a case to the Appellate Division generally requires the additional time and cost involved in the taxpayer and its representative having to travel to the Appellate Division office. In Virginia, for example, taxpayer will confer with appellate conferee in Richmond.

25. Taxpayer must pay the assessed tax deficiency in full in order to bring suit in the District Court or Court of Claims. Flora v. United States, 362 U.S. 145 (1960).

26. Venue would lie in the judicial district where the taxpayer's principal office is located. 28 U.S.C. § 1402 (a) (2) (1962).

27. See, e.g., Burford-Toothaker Tractor Co. v. Commissioner, 192 F.2d 633 (5th Cir. 1951); Wright-Bernet, Inc. v. Commissioner, 172 F.2d 343 (6th Cir. 1949).
other courts do not feel bound by the uncontradicted testimony of an expert.\textsuperscript{28} But more important than the evidentiary factor is the precedent factor. What do prior cases on reasonable compensation show as to the court’s attitude on the subject? This is not a simple question to answer. Because each reasonable compensation case depends so much on its own facts, it is sometimes difficult to savour a court’s leaning. It has occurred in the past that judges of the same court, acting upon essentially the same facts, have arrived at different conclusions as to reasonable salary.\textsuperscript{29}

There is one result which does appear consistently, regardless of judicial forum. A review of the reported cases\textsuperscript{30} will reflect a definite tendency on the part of the court to do that which the parties themselves have not been able to do: compromise the amount of salary at a figure somewhere between the two extremes taken by the parties. There are decisions sustaining the taxpayer in toto, and there are cases fully upholding the Government’s assessment, but the more usual result is a compromise verdict.

This brings us back to the original statement as to the importance of settling at the earliest possible stage. After all the time and expense have been incurred in litigation, quite often the same result could have been achieved at the first conference stage. The reported cases make it quite clear: it behooves the parties, taxpayer and Government alike, to act as reasonable, informed persons from the start; if they do, a settlement equitable to both can be reached with a minimum of time and expense.

\textsuperscript{28} See, e.g., Perlmutter v. Commissioner, 373 F.2d 45 (10th Cir. 1967) aff’g 44 T.C. 382 (1965); R. H. Oswald Co. v. Commissioner, 185 F.2d 6 (7th Cir. 1950).

\textsuperscript{29} Compare Seven Canal Place Corp., 21 CCH Tax Ct. Mem. 1661 (1962), remanded for further proof 332 F.2d 899 (2nd Cir. 1964) (Judge Opper of the Tax Court found $5,200 to be reasonable for 1955) with Seven Canal Place Corp., 23 CCH Tax Ct. Mem. 1643 (1964) (Judge Pierce of Tax Court held $7,600 to be reasonable for 1956). It should be noted in this regard that each taxable year will stand on its own, rising or falling upon its own particular facts, so that a salary established as reasonable for one year is not binding upon later years. Glenshaw Glass Co., 13 T.C. 296 (1949), acquiesced in 1950-1 Cum. Bull. 2. See note 39, infra, as to effect of Service’s acceptance of compensation for prior years.

\textsuperscript{30} Various publishers of tax treatises maintain up-to-date charts reporting recent decisions on reasonableness of compensation. These tables of comparative salaries reflect the type of business involved, its sales, gross and net income, stock holdings, etc., together with the amount of compensation allowed. See, e.g., R.I.A., Tax Coordinator 26,351 (Appendix to Chapter H) and 26,369 (Supplemental Appendix I); 1 CCH 1968 St. and Fed. Tax Rep. ¶ 1372.017.
Resolution of the Issues: The Facts Govern

If a reasonable taxpayer and a reasonable member of the Conference Staff or of the Appellate Division, each fully informed as to the facts, put their heads together and apply the rules of reasonable compensation in a good faith effort, the case should be disposed of by settlement agreeable to all concerned. The officer-owner of taxpayer corporation may not particularly relish the settlement made, but generally he will realize that the whole area of what is reasonable and what is excessive is nebulous. While he would have preferred the allowance of a higher salary, he will recognize the practicality of the situation and approve the settlement negotiated.

In the conference stage it becomes the task of the taxpayer to make the most of each of the factors governing the determination of reasonable compensation. The taxpayer must make the most of it, for the Government representative will certainly make the most of each factor to buttress the Government's case. The conferee will point out the high ratio of officers' salaries to gross income. He will quote lower salaries paid by comparable concerns in the same industry. He will note the absence of dividends distributed to the stockholder-officers.

On the other side, the taxpayer will emphasize growth of the company's business, reciting that such growth has been due to the efforts of the officer whose salary is being questioned and which officer has been grossly underpaid in the past. If the taxpayer can ascertain data as to equivalent salaries paid by competitors, he will quote those figures, although as a practical matter it is difficult to obtain this type of information.

And so the argument goes on, each side citing the factors in its favor. It is at this point that the taxpayer must move forward if settlement is to be effected. After all, the conferee has reviewed the entire file, and

35. Cf. Perel & Lowenstein, Inc. v. Commissioner, 237 F.2d 908 (6th Cir. 1956). Payment for services rendered in earlier years is properly deductible if such is not unreasonable when added to what has been paid for the earlier years. Lucas v. Ox Fibre Brush Co., 281 U.S. 115 (1930).
36. See note 30, supra, as to availability of information published in comparative reasonable compensation charts. However, such information is often more general than that required for taxpayer's most effective case. Specific data from competitors would be the best evidence, but as a practical matter is not available.
is trying in good faith to make a settlement which is thoroughly justifiable to the Revenue Service. He may well be disposed to settle, but he needs a peg upon which to hang his hat. Therefore, the taxpayer must adduce the facts which lift his case out of the classification initially defined by the revenue agent. The taxpayer must show that the "comparable" concerns cited by the agent and the conferee are not comparable at all because of the peculiar facts in his own case.

This is neither mere semantics, nor is it simply predominance of advocacy. It is rather a precise showing of the facts. For each case does have its own peculiar facts, and if these facts are carefully analyzed and ably presented to the conferee, he will then appreciate that something does exist which is special to taxpayer's case and which will justify allowance of compensation additional to that proposed by the agent or initially contemplated by the conferee.

In each of the case studies, the facts were analyzed and urged before the member of the Conference Staff or the Appellate Division, as the case happened to be. As will be shown, in each case there existed a peculiar fact situation which elevated the case and justified the settlement of compensation agreed upon.

Case No. 1—Trans Porter's Relationship to Big Op. It will be recalled that Trans Porter had left school at an early age, driven a tractor-trailer, purchased his own rig, formed his own corporation, and caused that operation to grow into a fleet of a hundred trucks. The revenue agent audited the corporate books, determined that the salary paid to Trans was excessive, and proposed to reduce it substantially. On appeal, at conference the conferee repeated the findings of the agent, noting that the salary was extraordinary when compared with salaries paid to officers of several like concerns (whose tax returns were available to agent and conferee). He argued that Trans' salary bore a high ratio to sales (lease rentals), and he found that the corporation had distributed its earnings through dividends in modest amounts.

Present at the conference were Trans, his attorney, and his accountant. Although Trans was not required to be present, his attorney had resolved that Trans would make a good witness for his own cause, and so had recommended his attendance at conference. In response to the position taken by the conferee, the attorney quoted statistics favoring

37. Taxpayer's written protest, which is filed prior to the conference, is signed and sworn to under penalty of perjury. However, there is no sworn testimony at conference as it is generally conducted on an informal plane.
allowance of the salary paid to Trans. The attorney had access to several trucking concerns who were willing to permit disclosure of salary amounts, provided their names should be withheld from the Revenue Service (obviously not desiring an audit for themselves). While quotation of salaries paid by these comparable concerns had some weight, it was substantially lessened by the fact that the attorney was not privileged to disclose the concern names.

The attorney also urged the long hours and hard work on the part of Trans and the fact that the method of computing his base salary and bonus had been well established prior to the taxable years under audit. Finally, the attorney pointed out that the corporation's returns for the prior years had been examined and the officers' salaries allowed as claimed.

A stalemate was reached, and it behooved Trans to go forward or lose his appeal. Go forward he did, by pointing out to the conferee the truly outstanding fact in his particular case, namely, that Trans Porter, Inc., was no mere trucking-leasing concern. Instead, it was the solid transportation arm of Big Op, and Trans' salary had to be viewed in this important light.

The "Protest" filed by Trans prior to conference had cited this relationship, and Trans' attorney now called upon him to relate full detail as to his role in the growth and successful operation of Big Op. The conferee became satisfied that, in all fairness, one could not view the operation of Trans Porter, Inc., separate and apart from its relationship with Big Op. The importance of Trans as a highly qualified transportation executive in the operation of Big Op and, to a limited extent, as an advisor in other affairs, became obvious to the conferee. So also did the personal and mutual confidence which existed between Trans and the officers of Big Op.

While there was discussion toward settlement of the salary issue, no resolution of the issue was made during the conference, but it was agreed that Trans, his attorney, and his accountant would consult and thereafter propose to the conferee what they considered to be an equitable compromise. Upon study and consultation, the attorney and the accountant recommended to Trans a compromise figure, which he agreed

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39. It has been held by one court that where the Revenue Service has accepted as reasonable the amount of compensation for earlier years, there should be "some obligation . . . by the Commissioner to show that it was all a great mistake." Seven Canal Place Corp. v. Commissioner, 332 F.2d 899 (2d Cir. 1964).
should be submitted. The conferee, after consideration, agreed to the sum as proposed.

It is interesting to note that the conferee requested a supplement detailing in writing the relationship of Trans Porter, Inc. as the transportation arm of Big Op which Trans had verbally described during conference. This was the key fact, and the conferee wanted it carefully documented in order that his recommendation for settlement might be approved by his reviewer.\(^{40}\)

**Case No. 2—Sales Co.: The Personal Selling Ability of the Officers.**

It will be recalled that Sales Co. had been formed as a separate corporation to handle the sales of Plant Co. products and had been immensely successful, due primarily to the efforts of its officers-owners. Upon audit, the revenue agent in charge insisted that the salaries were excessive in each case and should be reduced.

On appeal, before conferee, the battle ensued. In addition to the usual arguments advanced by the Government was one peculiar to this case, namely, that one officer was also an officer of Plant Co., where he already enjoyed a substantial salary.\(^{41}\) In rebuttal, Sales Co. urged that if the subject officer deserved the salary paid to him by Sales Co., it made no difference what salary or salaries he might receive from other companies. Sales Co. pointed to the growth of the company and of the sales of Plant Co. products and urged that the officers had been greatly under-compensated during the early years.

A stalemate was reached, but Sales Co. produced the key fact which would prevail and make possible the settlement ultimately agreed upon. This fact was the personal sales efforts of the officers themselves. The subject salaries could not be justified as compensation paid to admin-

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\(^{40}\) It is also interesting to note that there was no “trading” of figures before arriving at the reasonable compensation agreed upon. That is to say, Trans and his representatives did not propose a higher figure, being prepared to settle for a lower figure which might be counter-offered by the conferee. Instead, they arrived at what they honestly considered to be a salary which would be acceptable. They proposed that sum to the conferee, advising that it was not a trading figure, and that it should not be acceptable to the conferee, the matter would have to be litigated. This, of course, is a question of tactics. Some taxpayers and some representatives naturally like to trade. Others prefer to move directly to their settlement figure and then litigate if it is not accepted. In each of the three case studies in this article, settlement was made in a direct manner, there being no trading once the acceptable salary had been determined and proposed.

\(^{41}\) The Government’s argument on this score was not entirely clear. Presumably, it was premised on the reasoning that the subject officer had to spend part of his time and effort with Plant Co., thereby reducing his availability and actual time devoted to Sales Co., the taxpayer.
istrative officers. Instead, Sales Co. had to show that the officers continued to function as salesmen, producing through their personal efforts the vast increase in sales of Plant Co. products. When considered more as salesmen than as staff executives, their salaries were totally within reason. So Sales Co. had to make clear to the conferee just how important a personal sales role its principal officers played. At the conference, the principal officers testified that they were directly responsible for approximately seventy-five per cent of the total sales of Plant Co. products. One of the officers handled a large account for which the standard salesman’s commission would have exceeded the total salary paid to the officer. In a number of instances, sales were handled directly by the principal officers, for which commissions were paid to Sales Co.’s local sales representatives in the area. Based upon the facts as to the principal officers’ spending the greater portion of their time actually handling and being responsible for sales of merchandise, which facts the conferee requested be detailed in supplement to the original protest, a settlement equitable to both the Government and the taxpayer was achieved.

One feature of the Sales Co. case bears additional comment. As noted previously, Sales Co. was owned by the principal officers whose salaries were questioned. It served as exclusive sales agent for Plant Co., whose ownership was held diversely and whose officers’ salaries were not questioned. Presumably, had Sales Co. been wholly owned by Plant Co. instead of by its individual officers, the salaries of Sales Co. would not have been questioned. And nothing exists in the record to indicate that salaries of lesser amounts would have been paid by Sales Co. as a wholly-owned subsidiary of Plant Co.

The fine line drawn between a closely-held and a publicly-held company for reasonable compensation purposes can be quite misleading. In many instances, the inactive stockholders of a family-owned corporation scrutinize with utmost care the salaries paid to the active members of the family. This is in contrast to some parent-subsidiary situations where the publicly-owned parent permits its subsidiary to operate pretty much on its own, with substantial salaries, so long as net profits continue to be generated. In fact, there can exist the anomaly of the salary of the chief officer of a family corporation being questioned in

42. There is a tendency to be more liberal in allowance of substantial compensation for personal services, such as sales. This stems from recognition by the courts that the success of the business has resulted more from the efforts and skills of the officers than from use of capital. See, e.g., Kay, Inc., 8 CCH Tax Ct. Mem. 911 (1949).
one year, but not the following year when the corporation's stock is acquired by a public concern who effects no change in its new subsidiary's salary scale.

**Case No. 3—Better Mousetrap, Inc.: Sale to National Concern.** This leads directly into the third case study where the business of Better Mousetrap, Inc., so successfully built up by the Capable Brothers, was sold to National Concern. As a result of the sale, there was an audit by the Revenue Service, with the agent in charge proposing to reduce substantially the salaries paid by Better Mousetrap, Inc., in previous years to the two brothers.

There could be no question as to each brother being entitled to a substantial salary. Both had worked long and hard and had taken reduced salaries in the early years of building up the business. It had been their inventive genius which led to the company's unique product.\(^43\)

When the agent made his proposal, the company's able general counsel went to work immediately, obtaining affidavits from knowledgeable businessmen in the area as to the reasonableness of the compensation paid to the brothers.\(^44\) One affiant related the history of the growth of the company and concluded with his opinion that the salaries paid were thoroughly within reason. Another affiant, president of a local but unrelated concern, testified that in his opinion the salaries were not excessive when compared with salaries paid to key officials of other concerns in that community. Despite the urging of taxpayer's attorney and the positive, unequivocal statements made by top businessmen in the area, the agent remained firm and sent in his report calling for the reduction of salaries.

On appeal, all facts which had been presented to the agent were reiterated in conference before the conferee. But, in addition, a new fact was brought out, one which had substantial bearing on the conferee's agreement with the taxpayer's attorney for settlement. Between the time of the agent's examination and report, and the date of the conference, Better Mousetrap, Inc., was able to obtain expert opinion of the highest quality. Such opinion came from the purchaser of the business. By affidavit, the president of National Concern, whose stock was publicly traded, testified that at the time National had looked at the operations of taxpayer toward the end of acquiring same, the sal-

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\(^{44}\) See notes 27 and 28, *supra*, regarding evidentiary importance of expert testimony.
aries of the principal officers had been reviewed and the determination made that they were perfectly reasonable. Further, testified National, it entered into agreements with the two brothers to pay what it considered to be the equivalent of the salaries paid prior to acquisition. In the case of one brother, National agreed to a consultant arrangement, under the terms of which his salary was reduced by a specified fraction, but so was the amount of time required of him. Similar agreement was reached with the other brother, calling for reduction in compensation accompanied by reduction in time and responsibility, and expressly recognizing his right to devote himself to other business interests.

The salient points contained in the affidavit of the chief officer of the acquiring corporation were brought to the attention of the conferee. After the conferee and taxpayer's attorney had completed review of the controlling facts and the relevant principles, the conferee inquired as to what salaries the attorney considered reasonable under all the circumstances. The dollar amounts stated by the attorney were precisely those which the conferee believed reasonable. Accord was thus reached by two persons comprehending the law and the facts, and earnestly exerting every effort to reach an equitable solution.45

CONCLUSION

The area of reasonable compensation is a fascinating segment of tax law. It should be particularly interesting to the general practitioner. The legal principles are relatively simple and well established, so that the real thrust in the reasonable compensation case is the assembling and presentation of the facts, the lawyer's bailiwick. Each case will have its own peculiar twist, its own singular feature which will take it out of the norm and, hopefully, justify the position advocated by the taxpayer. It is up to the taxpayer's attorney to marshal these facts and to make them known to the Government representative. The one feature which makes the case stand out from comparable cases cited by the Government and which justifies the compensation claimed by the taxpayer must be set forth clearly and forcefully.

45. One factor was present in the Better Mousetrap, Inc. case which taxpayers will face more often in future reasonable compensation cases because of the prevalence of profit-sharing and pension plans. In determining total compensation paid to an officer, the Government will include contributions made by the taxpayer-employer to the officer's account in the company retirement plan. See, e.g., R. P. Farnsworth & Co. v. Commissioner, 203 F.2d 490 (5th Cir. 1953); Charles E. Smith & Sons Co. v. Commissioner, 184 F.2d 1011 (6th Cir. 1950), cert. denied, 340 U.S. 953 (1951).
While it will be a rare case in which the revenue agent can be persuaded to alter his determination to adjust the salary, there is no reason why disposition cannot be made on the appellate level, preferably at the Conference Staff, but if not there, certainly at the Appellate Division. If the issue be not resolved within the appellate ranks of the Revenue Service itself, the final arbiter will be the court, whether it be the Tax Court, the United States District Court, or the Court of Claims. The chances are that the court will make the same resolution as to compromise between the two extremes sought by taxpayer and Government, which could have been effected by the parties earlier, at less time and cost to all concerned.