The Financial Valuation Group

WHEN RESULTS COUNT

TAX VALUATION E-FLASH

Special Edition

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Herold Marketing Associates v. Commissioner, T.C. Memo. 1999-26, January 29, 1999

The IRS claimed that $700,000 of the $1,200,000 in compensation paid by the taxpayer to its sole shareholder, sole board member, and chief executive officer was not deductible as reasonable compensation. The Judge Laro cited 14 factors to consider in reaching a conclusion on the reasonableness of compensation:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's work;
3. The size and complexities of the employer's business;
4. A comparison of salaries paid with the employer's gross and net income;
5. The prevailing general economic conditions;
6. A comparison of salaries with distributions to officers and retained earnings;
7. The prevailing rates of compensation for comparable positions in comparable concerns;
8. The salary policy of the employer as to all employees;
9. The amount of compensation paid to the particular employee in previous years;
10. The employer's financial condition;
11. Whether the employer and the employee dealt at arm's length;
12. Whether the employee guaranteed the employer's debt;
13. Whether the employer offered a pension plan or profit-sharing plan to its employees; and
14. Whether the employee was reimbursed by the employer for business expenses that the employee paid personally.

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Judge Laro presented a detailed analysis of these factors, including the CEO's "workaholic" predilection. The only expert testimony apparent in the opinion dealt with item seven - prevailing rates of compensation for comparable positions. Judge Laro was not, however, persuaded by either expert. The taxpayer expert limited his analysis to companies identified in the IRS engineering report that was used by the IRS in their audit. The expert concluded that the companies in this analysis were, "reasonably comparable, not totally comparable." Unfortunately, this expert was used to rebut a document the IRS did not introduce at trial as part of the record.

The IRS expert was also criticized. Judge Laro did not believe the companies this expert used were sufficiently comparable. The Judge was also skeptical of the sample size used, the number of non responses to the survey conducted by the expert, and the way the expert considered blank answers to his survey questions as negative responses.

After considering the items in the list, Judge Laro concluded the total amount of compensation paid was reasonable and therefore, deductible.

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