



# WHEN RESULTS COUNT

## TAX VALUATION E-FLASH

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### LabelGraphics v. Commissioner

U.S. Ninth Circuit Court of Appeals, August 8, 2000

The U.S. Ninth Circuit Court of Appeals has affirmed the US Tax Court in *Label Graphics v. Commissioner*, T.C. Memo. 1998-343. The Tax Court had determined that the 1990 reasonable compensation for its president and sole stockholder, Lon Martin, was \$406,000 (\$156,000 salary and \$250,000 bonus). On the original return, the company had claimed \$878,913 as a compensation deduction and the IRS had disputed all but \$245,600 of the deduction.

Under the Internal Revenue Code, a corporation may deduct a reasonable allowance for salaries or other compen-

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sation for personal services actually rendered. When payments are made to an individual who is both a corporate employee and a principal shareholder, a two-prong test is applied to determine whether the distribution is truly compensatory. First, the amount of compensation must be **reasonable**; second, the payment must be **purely for services**, or have a purely compensatory purpose. Generally, the second part of this test is not invoked.

For the reasonableness test, the Court applied the "Elliotts" factors. The Ninth Circuit noted: "In Elliotts, we set out five broad factors that are relevant to the reasonableness inquiry: (1) the employee's role in the company; (2) a comparison of the employee's salary with those paid by similar companies for similar services; (3) the character and condition of the company; (4) potential conflicts of interest; and (5) evidence of an internal inconsistency in a company's treatment of payments to employees. 716 F.2d at 1245-47. No single factor is decisive. Id. at 1245. When conducting the reasonableness inquiry, 'it is helpful to consider the matter from the perspective of a hypothetical independent investor. A relevant

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- Purchase Price Allocations
- ESOP Values
- Economic Damages
- Corporate Dissolutions
- Shareholder/Partner Disputes
- Marital Dissolutions
- Estate and Gift

inquiry is whether an inactive, independent investor would be willing to compensate the employee as he was compensated.' Id."

The case contains an extensive discussion of the application of these factors to LabelGraphics, Inc.:

### 1. The Employee's Role in the Company

The Court concluded that Martin played a pivotal role in the corporation. The compensation for 1990, however, was more than double the compensation for any of the previous six years. One common rationale for an extraordinary increase in compensation is that the compensation is mak-

"...these experts offered no details on which to base a comparison and failed to show a meaningful connection between LabelGraphics and the companies that they claimed were comparable..."

ing up for previous undercompensation. In this case, no evidence was presented for this argument. The company's expert witness claimed past undercompensation, but in the view of the Tax Court, no analysis or conclusion supported the claim and the Ninth Circuit concurred.

### 2. A Comparison of the Employee's Salary with Those Paid by Similar Companies for Similar Services

The Ninth Circuit opinion noted, "As the Tax Court explained, however, these experts offered no details on which to base a comparison and failed to show a meaningful connection between LabelGraphics and the companies that they claimed were comparable. A review of the experts' reports and their testimony supports this conclusion."

### 3. The Character and Condition of the Company

The Tax Court found the company to be extremely well managed and, as one would expect, the company did not dispute this conclusion.

### 4. Potential Conflicts of Interest

Because Martin was the sole shareholder, the Tax Court's approach to this test was to take the perspective of an independent shareholder. On appeal, the company argued the Tax Court was incorrect in measuring the rate of re-

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turn solely on book value rather than the market value of the equity. The Ninth Circuit did not find the company's arguments convincing.

### 5. Evidence of an Internal Inconsistency in a Company's Treatment of Payments to Employee

The Tax Court concluded the 1990 bonus represented a departure from the normal bonus practice and the Ninth Circuit agreed.

### Conclusion

The Ninth Circuit concluded, "The Tax Court carefully applied the five factor Elliott analysis and found that Martin's total compensation for fiscal year 1990 was unreasonable. In so doing, the court fulfilled its obligation to 'spell out its reasoning and to do more than enumerate the factors and leap to a figure intermediate between petitioner's and the Commissioner's.' Leonard Pipeline Contractors, Ltd., 142 F.3d at 1135. Benchmarking an independent investor's expectations and recognizing that, despite a slight decline in 1990, Martin had done an excellent job in managing LabelGraphics, the Tax Court held that \$406,000 (\$156,000 salary and \$250,000 bonus) was reasonable compensation to Martin for 1990. We hold that the Tax Court's determination was not clearly erroneous."

[Click Here for a Complete Copy of the Case](#)

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