WHEN RESULTS COUNT

TAX VALUATION E-FLASH

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Metro Leasing and Development v. Commissioner, T.C. Memo 2001-119, May 18, 2001

The Tax Court held that Metro Leasing and Development Corp. was entitled to deduct a portion of officer's compensation disallowed by the IRS, but that it accumulated retained earnings beyond the allowable amount.

George Valente was the sole shareholder in Metro Leasing and Development Corp., an auto leasing and real estate development firm. Mr. Valente became ill and he and his wife operated the firm under a "cooperative" arrangement. Metro Leasing deducted $240,000 and $460,000 in 1995 and 1996 as compensation to the couple; however, the IRS asserted that the company was only entitled to deduct $77,000 for each year as reasonable compensation under section 162(a). In addition, the IRS determined that Metro Leasing had allowed its earnings to accumulate beyond the reasonable needs of the business and was, therefore, subject to the accumulated earnings tax.

The Tax Court sustained a part of the IRS position using the five-factor test in Elliotts Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983) and by applying the independent investor test. The court found that income from the sale of assets during 1995 and 1996 was due to the Valentes' efforts and concluded that reasonable compensation for those years was $90,000 and $163,000.

As to the accumulation of retained earnings, the court held that Metro Leasing was a "mere holding company" within the meaning of section 533(b) and, therefore, had a purpose of avoiding income taxes on its shareholders. The court held that Metro Leasing was limited to $250,000 in retained earnings.

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