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# Reasonable Corporate Salaries

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# REASONABLE CORPORATE SALARIES

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Corporations, under Section 23(a)(1) of Internal Revenue Code, are afforded deductions in computing net income of all ordinary and necessary expenses paid or incurred in carrying on any trade or business, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." The decisions which have interpreted this Section, present in every Revenue Act since 1918, indicate that there are three tests for determining reasonable salary deduction: (1) Is the payment in fact salary or other compensation; (2) Have personal services been actually rendered; and (3) Is the payment reasonable when measured by the amount and quality of the services performed with relation to the business of the particular taxpayer?[1]

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64. Dissenting opinion in Felix Zukaitis, 3 T. C. ——, No. 102.
65. Dissenting opinion in J. D. Johnston, 3 T. C. ——, No. 101.

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1. See Lenox Clothes Shops, Inc. v. Commissioner of Internal Revenue, 139 F. (2d) 56 (C. C. A. 6th, 1943). See also Mertens, "Law of Federal Income Taxation" § 25.44.

It is expected that these tests will be applied frequently in the future. The great increase in corporate profits and the increasingly heavy tax burdens on corporations, together with increased costs of living of employees caused the corporations to grant substantially higher corporate salaries even before the salary and wage controls were put into effect. I do not intend to discuss the effect of those controls upon the allowances by the Treasury Department of corporate salaries as reasonable in amount, but I think it is agreed that any increases granted by the National War Labor Board or the Salary Stabilization Unit of the Treasury Department will be a substantial deterrent to the Commissioner's holding that such corporate salaries are unreasonable; on the other hand, I think it must be admitted that the Commissioner is not required to hold such salaries reasonable merely because they have been approved by those agencies. We trust that these controls are of only a temporary nature, but it is expected that salaries prior to the institution of those controls and also subsequent thereto will be subjected to these three time honored tests. So let us consider them, the factual situations to which they have been applied and the decisions of the Court resulting from their application.

*Is the payment in fact salary or other compensation?* In determining whether a payment to an employee of a corporation is compensation for services, it is well to inquire "if the payment is not salary, what is it?" Well, (1) it might be a distribution of profits, or dividends in the form of a salary payment, or (2) it might be actually payment for the purchase of property, or (3) it might be a gift.

1. In a close corporation, the temptation is very great to distribute profts in the form of salaries. Let us assume a case in which one stockholder owned sixty per cent of the stock and another forty per cent of the stock, both being actively employed by the corporation. Let us further assume that each drew $10,000.00 compensation for the year 1938, in which a profit of $25,000.00 was made. In 1939 the profit would have increased $10,000.00 except for the fact that the larger stockholder's salary was increased $3,000.00 and other stockholder's salary was increased $2,000.00. It can easily be seen that it would be difficult to convince the Commissioner that these increases, being in direct proportion to the stockholdings were not actually div-

idends in disguise. It is easy to see that the weak points in the taxpayers' case are that the increases are directly proportional to the stockholdings and that the stockholders have no interest in bargaining with themselves to keep their salaries low, but on the contrary stand to make substantial tax savings if the highest maximum salaries are paid. Such increases in salary are subject to the closest scrutiny, and when determined to be not salary but a distribution of profits, the presumption in favor of the correctness of the Commissioner's disallowance of the excessive salaries can be overcome in the Court only by the clearest proof.[2]

2. An example of an ostensible salary payment which is in reality a payment for property is given in the Regulations.

> "This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business."[3]

Another illustration is where a selling agent is paid a commission both for sales and also for his promise not to engage in a similar competing business during the life of the contract. Insofar as the commission is paid for refraining from engaging in business, it is a payment for property.[4]

It is infrequently contended that payment to an employee constitutes a gift. The question may arise when the recipient excludes that amount from his own gross income while the corporation tried to take a deduction for that amount as compensation. Such a case arose in *Willkie vs. Commissioner*,[5] Wendell's brother, Herman, resigned in 1937 from one of the Hiram Walker corporations. In accepting his resignation, the Board moved that he be given a check for six months' salary in appreciation of his services. The recipient refused to accept this at first but upon being told that the "gift" had been unanimously voted, he thereupon accepted it. The

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2. Cf. C. S. Ferry & Son, Inc. v. Commissioner of Internal Revenue, 18 B. T. A. 1261 (1930); General Water Heater Corporation v. Commissioner of Internal Revenue, 42 F. (2d) 419 (C. C. A. 9th, 1930).
3. C. C. H. Fed. Tax Serv. 157, Reg. 103, § 19.23 (a)-6 (1942).
4. 3 Cum. Bull 133, L. O. 1045 (1920).
5. Willkie v. Commissioner of Internal Revenue, 127 F. (2d) 953 (C. C. A. 6th, 1942).

paying corporation treated it as a deductible expense, and this was one of the factors taken into consideration in deciding that the recipient had to treat it as taxable income to him and not a gift.

The leading case on this subject is probably *Bogardus vs. Commissioner.*[6] Unopco Corporation took over the assets and business of the Universal Company, and the stockholders of the successor corporation voted "gifts or honorariums" totalling $600,000.00 to the employees of the Universal Company. The Supreme Court held by a five to four decision that the Tax Court decision should be overruled, and that the recipients of those so-called gifts were not taxable thereon. One of the relevant factors considered was that the paying corporation had not sought any deduction from its federal tax on account of those payments. It is thus clear that consistent treatment by both the payor and the payee in these situations is required to show that the payment is a gift.

*Is the payment made for personal services?* Payments to the members of the family of the dominant stockholder or principal operator of the business often fail before this test. Theoretically that relationship should not affect the action of the Board of Directors in determining a reasonable salary, but such situations invite the closest scrutiny by the Bureau of Internal Revenue, and where the services performed are not substantial, a disallowance will be upheld. In addition, where the motivating factor of payment is the desire to reduce an employee's indebtedness[7] or to make a loan[8] or to aid a sick employee,[9] it is considered that the payment is not for personal service actually rendered. It should be noted, however, that salaries paid to former employees who are now in military service are allowable as a deduction.

*Is the compensation payment reasonable?* Undoubtedly the factual determination of the reasonableness of the compensation paid is of utmost importance. Because the question is one of fact, and because practically every situation involves some difference in fact, only generalization can be

6. Bogardus v. Commissioner of Internal Revenue, 302 U. S. 34 (1937).
7. Foregger Co., Inc. v. Commissioner of Internal Revenue, 13 B. T. A. 920 (1928).
8. Kossar & Co., Inc. v. Commissioner of Internal Revenue, 16 B. T. A. 952 (1928).
9. Snyder & Berman, Inc. v. Commissioner of Internal Revenue, 116 F. (2d) 165 (C. C. A. 4th, 1940).

made. Even before the recent decision emphasizing the finality of Tax Court decisions on matters of fact, the upper courts have been reluctant to change the holdings below. A careful presentation of the case is therefore necessary, at the earliest opportunity, if the corporate taxpayer's deductions are to be sustained. Like the determination of any ultimate fact, the reasonableness of the compensation requires the consideration of many different factors.

Where the directors deal at arms' length with employees in the fixing of salaries, the amounts agreed upon as a result of such a bargain are generally accepted. This guarantee of reasonableness, however, is quite often lacking, as the salaries in question are usually those of persons who dominate and control the directors. In such cases, the action of the board of directors has very little weight with the Commissioner and with the courts. And if the Commissioner determines compensation to be of an unreasonable amount, the taxpayer has the burden of overcoming the presumption in favor of the correctness of the Commissioner's determination. He can do this by showing the amount to be reasonable. If it can be shown that a like enterprise, under like circumstances, would ordinarily pay the same amount for like services, the compensation will be deemed to be reasonable.

With this in mind, it becomes apparent that factors to be considered are the size of the enterprise, the area in which it is located, the type of industry represented, the general economic conditions, the financial soundness of the corporation, the result obtained under the employment contract, the ratio of the questioned salary to other salaries within the business and similarity of employees in like industries with similar qualifications, the salary policy of the corporation, the employees' qualifications and the scarcity of other persons with comparable qualifications, the amount of time devoted to the business, and every other consideration that may enter into the question of whether an employee is worth what he is being paid. In the usual case, some of the facts will indicate that the salary paid is reasonable; while others will operate to show the opposite. A determination, however, is not so difficult as the abstract weighing of these factors would indicate, because in a particular case the decisive factors usually are apparent. It would require too much time to illustrate the application of all these factors by cases, and so only a few isolated examples will be used.

The case of *William S. Gray & Co. vs. United States,*[10] is often cited by the taxpayer and with good reason. The plaintiff was a New York corporation engaged in importing and exporting chemicals. During the years 1916, '17 and '18, compensation was paid to six key employees in amounts ranging from $7,500.00 to $257,714.30. This maximum was received by Mr. Gray in 1916, and in 1917, he received $139,000.00 and in 1918, $84,000.00. The Company practice had been to use all of the profits in excess of 7% of the capital stock as bonuses to be distributed among key employees. Mr. Gray owned 80% of the stock, but his bonus was only 57% of the profits. The salaries paid were declared to be reasonable, and the following factors there considered seem to be controlling:

(a) Although the corporation was closely held, bonuses granted were not in proportion to stockholdings.

(b) The Company's practice of determining bonuses had been fixed and applied for some time previous to the years in question.

(c) The business of the corporation was personal in nature, and its profits depended primarily upon the exertions of the key employees.

(d) The services by the corporation were almost unique (they imported approximately 95% of the acetate of lime and wood distillation business in the country), and it would have been difficult to have found other qualified employees. In a manufacturing chemical company, the three heads of the business received fixed annual salaries of $100,000.00 per year, and Mr. Gray's salary over a nine-year period amounted to $99,303.29 average per year.

The reasons this case is such a favorite of taxpayers are that very substantial amounts were approved to the chief stockholder of a closely held corporation, and it is a "bonus" case. And because the bonus or contingent method of compensation is related so closely to a distribution of profits, much litigation has resulted.

Theoretically, a payment of $10,000.00 per year with a $5,000.00 bonus is just as reasonable as a $15,000.00 salary for the same job. But the agent who examines the corpor-

10. William S. Gray & Co. v. U. S., 35 F. (2d) 968 (Ct. Cl., 1925).

ate return may regard the $10,000.00 per year salary as reasonable and the addition of another $5,000.00 out of the profits as excessive. He may be further convinced if he finds that the recipient is a large stockholder of the company and that he previously received only $10,000.00 per year. If that happens to a client of yours, you had better have some good answers.

What would be some good answers? Well, if you can show that he had received an offer from another company of $15,000.00 per year, that would be a very good answer. If you could show that some new line of business had been taken on successfully, that would help. If the company made sufficient money to pay greater dividends than usual—and did so—, or if his work was primarily concerned with sales, and commissions customarily paid in the industry would have approximated $15,000.00 if he had been so employed; or if you could show John Smith in the XYZ Company, who performed substantially the same services for a company in the same industry having about the same volume of business, received $15,000.00 or better; or if you could show that your client had had to employ a stranger at say $12,000.00 per year and the stranger had a less responsible job than the person who got $15,000.00; if you can show any or all of these factors, there is a good chance the agent will change his mind and allow the bonus. The point is, there has to be some good reason for paying particular amounts of salaries, or they are "unreasonable."

If one of your corporate clients has an officer's salary disallowed as unreasonable, in your search of cases to justify the allegedly excessive compensation, you will probably find the case of *Lucas v. Ox Fibre Brush Co.* useful.[11] In that case, $24,000.00 each was voted to two officers who had been with the company for seventeen years, and the compensation paid was allowed for past services. The business had grown and prospered under the guidance of these two employees, and these increased salaries were to make up for inadequate payment when the corporation was not so able financially. The resolution authorizing the payments recited that they were for past services, and that is probably an important distinction between your case and the Ox

11. Lucas, Commissioner of Internal Revenue v. Ox Fibre Brush Co., 281 U. S. 115 (1930).

Fibre Brush Co. case. The Courts are not inclined to regard favorably the principle of this case where it is brought forward as an afterthought. However, in *Webb & Bocorselski, Inc.*,[12] and *Detroit Vapor Stove Co.*,[13] among others, favorable consideration was given to the fact that prior years' salaries had been inordinately low.

Before discussing some practical suggestions, I would like to mention two recent cases: *Frederick Webb Estate v. Commissioner*, Tax Court Memo Opinion decided May 8, 1944 (reported in CCH as Dec. 13, 929(M.), and *J. L. Norie v. Commissioner*, 3 TC ——, No. 89 (CCH Dec. 13, 885).

In the *Webb Estate* case, some unlisted stocks were valued on the basis of capitalization of corporate earnings. Although the Commissioner had allowed the salaries for income taxes, the court held that the earnings of the corporation should be increased by the amount of salaries deemed excessive, and the value of the stock determined on the earnings as adjusted.

In the *Norie* case, it was held that the payment of salaries to employees who admittedly performed no services justified the imposition of the 50% fraud penalty. This case relies upon *Allegheny Amusement Co. v. Comm.*[14] and in the latter case, the fraud was availed of also to reopen many prior years.

These two taxpayers made no contention that any services were actually performed. Usually, some effort is made to show rendering of service, even if all that can be shown is that the wife (the Vice-President) sometimes discussed business affairs with her husband (the President) after dinner, and occasionally dropped in at the office. Well, maybe those services are valuable if they prevent the imposition of fraud penalties. In the case of *United States v. Ragen*,[15] however, it was held that criminal penalties for fraud may be upheld even though some slight service was rendered.

In conclusion, I wish to offer some suggestions.

1. When fixing corporate salaries, do it by formal resolution. And if an increase is granted for any particular reason, state the reason.

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12. Webb & Bocorselski, Inc. 1 B. T. A. 871 (1925).
13. Detroit Vapor Stove Co., 4 B. T. A. 1043 (1926).
14. Allegheny Amusement Co. v. Commissioner of Internal Revenue, 37 B. T. A. 12 (1938).
15. U. S. v. Ragen, 314 U. S. 513 (1941).

2. Fix salaries, especially contingent salaries, at the beginning of the year. This tends to show that compensation was determined with reference to a bargaining for services and not as a distribution of profits.

3. If increases are given to stockholder-employees, give some increases to non-stockholders, too.

These suggestions should help to avoid controversy, if the salaries are not extravagant.

If corporate salaries are disallowed, investigate your case from every angle and present it ably and early. Many a corporate salary case has been lost through inadequate preparation and poor presentation.

Try to find comparable enterprises, and back your argument with facts. This particular task is not easy, since competitors may not be too friendly, and don't forget that the Commissioner has more comparative data than you can hope to produce.

But you can analyze the employee's qualifications and responsibilties. You can show ratios of salaries to gross income, to net income and dividends. You can show other prior and subsequent offers for the employee's services, the additional duties imposed on him, the practical results obtained from his services, the cost of replacing him, the comparative unemployment cycles, general business conditions, the economic history of the corporation; if the employee is on a salary basis, what he would have made on commissions; if on commissions, that the average over a period of years is no more than he would have received on a straight salary basis. Stress differences in compensation and stockholdings. Draw up comparative statements, analyses, charts.

Of course, all the factors you investigate won't be to your advantage. But you ought to find enough favorable indications to satisfy yourself that the employee didn't get half enough.

The Government has a strong defense in the presumption that the Commissioner's determination is correct. It is so strong that quite often it is the only defense offered, and it cannot be overcome just by citing cases. But it can be overcome with facts. So arm yourself with facts, and they will become the reasons that make the compensation "reasonable."