



## Reasonable Compensation Analysis Must Incorporate Applicable Legal Test

*Multipak Corp. v. Commissioner*, T.C. Memo. 2010-139 (June 22, 2010)

Over 30 years, a CEO brought a floundering packaging company to financial stability. In 2002 and 2003, his earnings exceeded \$2 million, nearly double the amount of prior years. The IRS claimed all but roughly \$650,000 per year was unreasonable under IRC Sec. 162, and the taxpayer appealed.

**Five-factor test controls.** The Tax Court applied the five factors in *Elliott's Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983), to determine reasonable compensation in this case, as follows:

1. *The employee's role in the company.* During his entire tenure, the CEO "made every important decision" for the firm, the court said, and his dedication "directly contributed" to its profitability. Although sales declined in 2003, the firm stayed current on its payables and was essentially debt-free. Overall the court found this factor weighed in the taxpayer's favor.
2. *External comparison.* The taxpayer's expert compared the CEO's compensation with the average executive pay from various S&P data, adjusting the comparables for their differences in size and types of compensation (including stock options). After these adjustments, the CEO's compensation was still high, among the upper range of the comparables, but still reasonable, the expert said. Further, the 2003 dip in sales was largely due to the economy, and there was no evidence the company paid bonuses to absorb taxable profit.

By contrast, the IRS expert applied the "independent investor" test derived from *Elliott's* (i.e., whether a third-party investor would be satisfied with the rate of return after investing in the company). Using data from comparable, industry, and the taxpayer sources, he concluded that \$1.46 million would have reasonably compensated the CEO in 2002 and \$670,100 in 2003.

The court wasn't "completely convinced" by either expert, finding their comparables "too dissimilar" to the taxpayer. Moreover, the taxpayer's expert did not perform the independent investor analysis, as "*required by the applicable case law*," the court held (emphasis added). Overall, this factor was neutral.

3. *Company character and condition.* The taxpayer was prominent in its industry and enjoyed record high revenues, despite its 2003 sales decline. The CEO contributed significantly to this success, weighting this factor in the taxpayer's favor.

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Page 2

4. *Conflict of interest.* The court examined this factor under the *Elliott's* independent investor test, noting that an investor would likely be satisfied with the 2002 rate of return but not in 2003, thus making this factor a wash.
5. *Internal consistency.* The compensation was not *per se* unreasonable simply because the CEO was a shareholder-employee, the court held. Moreover, the incentive-based compensation plan was a valuable motivator, weighting this factor in its favor.

Overall, the court found the CEO's compensation of \$2.02 million in 2002 was reasonable. It adjusted his salary to \$1.28 million in 2003, however, to produce a 10% return on equity, sufficient to satisfy "the overall character of the company" and an independent investor.