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Applying the Reasonableness Test to Executive Compensation

By: Dale Loepp, CPA, MST Student

Clary Hood, Inc. v. Commissioner, T.C. Memo 2022-15

In this era of comparatively low marginal tax rates, executive compensation in its myriad of forms has skyrocketed to levels previously unimaginable.¹ In such an environment it is sometimes easy to overlook that there are limitations on what constitutes a reasonable compensation deduction under Internal Revenue Code Section 162(a)(1). In *Clary Hood, Inc. v. Commissioner*, the Tax Court found that the CEO's compensation indeed exceeded a reasonable amount, limiting the corporation's deduction for Mr. Hood's compensation for the years 2015 and 2016.

Case summary

In 1980, Clary Hood and his wife founded Clary Hood, Inc., a subchapter C corporation in the land grading and excavation contracting business. Mr. and Mrs. Hood were the sole shareholders and board members, and Mr. Hood served as the CEO. In light of the company's striking success, the Hoods concluded in 2014 that Mr. Hood had been significantly undercompensated in his role as CEO during prior years. To rectify this perceived inequity, Mr. Hood and his wife set Mr. Hood's forthcoming salary in 2015 at \$168,559 and 2016 salary at \$196,500 and his 2015 and 2016 bonus at \$5 million. Other than Mr. Hood, no other executive at Clary Hood, Inc. had ever been compensated in excess of \$234,000 and none had ever received a bonus greater than \$100,000, and for the years in question, the amounts paid to Mr. Hood represented almost 90 percent of all compensation paid to all officers of the corporation.

The Tax Court held that the Clary Hood Inc.'s compensation deduction for Mr. Hood was limited to \$3,681,269 and \$1,362,831 for the 2015 and 2016 tax years respectively, due to the fact that Clary Hood, Inc. could not adequately establish any rationale for its calculation of Mr. Hood's salary and bonus.

The IRS issued a notice of deficiency, claiming that the compensation for 2015 and 2016 exceeded reasonable compensation as set out in Internal Revenue Code §162(a)(1). Total tax deficiencies amounted to \$1,581,202 and \$1,613,308 for 2015 and 2016 tax years respectively. Clary Hood, Inc. was also held liable for an accuracy-related penalty in the

¹ See for example, Lawrence Mishel and Jory Kandra, "CEO Pay Has Skyrocketed 1,322% since 1978," Economic Policy Institute: August 10, 2021, <https://www.epi.org/publication/ceo-pay-in-2020/>. Mishel and Kandra observe that "using the realized compensation measure, compensation of the top CEOs increased 1,322.2% from 1978 to 2020 (adjusting for inflation). Top CEO compensation grew roughly 60% faster than stock market growth during this period and far eclipsed the slow 18.0% growth in a typical worker's annual compensation....(T)he CEO to worker compensation ratio was 65-to-1 in 1965....In 2020 the ratio was 351-to-1."

amount of \$322,662 for 2016 since the corporation could provide no evidence that it had relied on the advice of competent professionals related to the compensation question for the 2016 tax year.

Tax issue addressed in this case

The primary issue addressed in this case is whether Mr. Hood's compensation met the test of reasonableness as set out in Code Section 162(a)(1) and relevant Treasury regulations, particularly Reg. 1.162-7, which requires that payment only be for actual services rendered and "only such amount as would normally be paid for like services by like enterprises under like circumstances" [(§1.162-7(b)(3)]. Although the corporation is free to pay its employees any amount it chooses, compensation in excess of a reasonable amount set by the Code cannot be deducted as an ordinary and necessary business expense for tax purposes, and any excess compensation would then be taxed as a dividend to Mr. Hood [§1.162-7(b)(1)].

Background

Since its founding, Clary Hood, Inc. had continually struggled with irregular revenue and net income. The Great Recession of 2008 significantly compounded these financial issues, forcing Clary Hood, Inc. to seek a more reliable source of work and cash flow at a time when many of his competitors were going out of business. Eventually the corporation turned to bidding on grading contracts with Walmart, with such contracts over time comprising 20 percent of its annual revenue. After experiencing constant downward pricing pressure and other frustrations with Walmart, in 2011 Mr. Hood decided (without input from other company executives) to discontinue bidding on Walmart contracts and to significantly diversify the corporation's customer base. This decision proved to be remarkably successful, and over the course of the next five years, the corporation's revenue grew by 342 percent. This increase in revenue reversed the corporation's net loss of \$120,530 in 2011 to a net income of \$14,537,867 in 2016.

Although the Hoods had periodically sought input from their accountants regarding Mr. Hood's salary and bonuses, they admittedly did not rely on any particular formula or industry comparisons to compute these amounts. Also, there were no pre-existing compensation agreements tying Mr. Hood's pay to corporate profitability. During the less profitable period from 2000-2011, Mr. Hood's salary varied, but averaged \$87,472, with a bonus averaging \$213,726 for the equivalent period. Thus, the \$168,559 salary plus \$5 million bonus set by the Hoods for 2015 and \$196,500 salary plus \$5 million bonus for 2016 represented a dramatic increase—though an increase that the Hoods claimed to be justifiable considering the corporation's profitability and via their discussions with internal accounting staff and external tax accountants. According to the Board of Director's minutes, the rationale behind the salary and bonus increases rested largely on Mr. Hood's performance at the company since 2011 and in large part was considered a correction of under-compensation in prior years.

Findings of the court

Generally speaking, determining whether compensation is reasonable as to amount depends on a consideration of all the facts and circumstances in any given situation;² compensating an employee for work done in a prior year is not in and of itself unreasonable.³ However, closely-held corporations are under particular scrutiny via Treasury regulations and the courts⁴ in discerning whether an “ostensible salary” is in actuality a disguised dividend that is “in excess of those ordinarily paid for similar services” [§1.162-7(b)(1)].

To evaluate reasonableness, the U.S. Court of Appeals for the Fourth Circuit, to which an appeal in this case would be referred, has a history of using what is known as the multifactor approach to determine reasonable compensation. As the term implies, the multifactor approach looks at a range of indicators to consider reasonableness; no one factor is decisive and the totality of the evidence must be weighed.⁵

In contrast, other courts have at times considered what is known as the independent investor test, wherein the corporation determines what an independent investor would be willing to compensate an employee based on the employee’s performance and the resulting return on investment.⁶ However, courts in the Fourth Circuit have not entertained such a test, relying instead, as noted, on the multifactor approach.

In this particular case, Clary Hood, Inc. attempted (unsuccessfully) to apply the independent investor test and partially lost their case. The corporation argued that Mr. Hood’s fifty years of experience in the industry, his great reputation in the industry, and the impeccable timing of his decision to diversify the customer base made his work so extraordinary and uniquely valuable to Clary Hood, Inc. that Mr. Hood’s compensation could not be accurately gauged against any industry comparisons. The corporation also argued that Mr. Hood should be compensated for guaranteeing the debt and surety bonds of the corporation, a practice which the court found customary under similar circumstances.

In applying the multifactor test to arrive at an amount deemed to be reasonable compensation, the court considered Mr. Hood’s background, his experience and qualifications and any unique services provided to the corporation; his position, the importance of the duties performed and number of hours worked; the size and complexity of the business; the proportion of compensation to net income of the corporation; past history of dividends; comparable compensation for comparable businesses; and the shareholder-employee’s salary history, especially when compared to non-shareholders’ salaries.

² See for example, Vernon E. Martens, T.C. Memo. 1990-42.

³ See *Lucas v. Ox Fibre Brush Co.* 8 FTR 10901 and *Pacific Grains v. Commissioner* 22 AFTR 2d 5413 (8/16/68).

⁴ For examples, see *Richland Medical Association v. Commissioner* TC Memo 1990-660 and *Estate of Wallace* 95 TC 525.

⁵ Again see Vernon E. Martens, T.C. Memo. 1990-42.

⁶ For an example of this principle as applied by the U.S. Court of Appeals, Ninth Circuit, see *Elliotts, Inc. v. Commissioner*, 52 AFTR 2d 83-5976.

Of these factors, the court found comparable industry compensation, the corporation's regular methods of setting compensation, and the corporation's dividend history to be the most compelling. While the court recognized the invaluable and pivotal contribution that Mr. Hood made to the company, the corporation ultimately could not identify any drastic change in Mr. Hood's duties to the corporation that would justify an abrupt 207 percent increase in his compensation, especially given that the amount far exceeded pay for comparable work in the industry. Salaries for non-shareholder employees had traditionally been set by Clary Hood, Inc. using unspecific, subjective factors such as the employee's ability to get along with people and the amount of pride taken in an employee's work. As a general practice, compensation levels at Clary Hood Inc. had no clear ties to corporate profitability.

Even though the corporation had more than sufficient cash on hand to pay a dividend, the court observed that Mr. Hood, as the controlling shareholder, chose to receive company profits in the form of increased salary and bonuses. Quoting from *Mulcahy, Pauritsch, Salvador & Co., LTD v. Commissioner*, the court observed that, "when a person provides both capital and services to an enterprise over an extended period, it is most reasonable to suppose that a reasonable return is being provided for both aspects of the investment, and that a characterization of all fruits of the enterprise as salary is not a true representation of what is happening."⁷ The court found that at least some portion of Mr. Hood's compensation consisted of a return on capital rather than a payment for services and computed those amounts on behalf of the taxpayer, resulting in a multi-million dollar tax and penalty assessment for Clary Hood, Inc.

Reasonable compensation deduction allowed by the court

While the tax court disallowed \$2,029,836 of Clary Hood, Inc.'s compensation deduction for 2015 and \$4,511,754 of the deduction for 2016, the amounts that were ultimately deemed deductible by the court were substantially higher than the original deduction amounts set forth by the IRS, as shown below:

| | 2015 | 2016 |
|-------------------|-------------|-------------|
| Claimed on return | \$5,711,105 | \$5,874,585 |
| IRS allowed | \$517,964 | \$700,792 |
| Tax Court allowed | \$3,681,269 | \$1,362,831 |

To set an amount for reasonable compensation in its ruling, the court relied heavily on comparable compensation data, as is frequently the case. To this end, Clary Hood Inc.—which has the burden of proof to support any tax deduction greater than that determined by the Commissioner—provided expert testimony from two sources. The first was the testimony of Mr. Samuel Kursh, who relied on a report co-authored by Mr. Kursh and Dr. Brett Margolin, both of BLDS, LLC, an economic consulting firm. To the detriment of Clary Hood, Inc.'s case, Mr. Kursh's testimony revealed a lack of knowledge about the underlying data supporting his firm's

⁷ *Mulcahy, Pauritsch, Salvador & Co., LTD v. Commissioner*, 109 AFTR 2d 2012-2140 (7th Cir.).

report and the court also observed faulty underlying assumptions, including compensation comparisons with much larger corporations such as Caterpillar, Inc. Ultimately, the court gave little or no weight to Mr. Kursh's testimony or the BLDS report.

The second expert testimony presented by Clary Hood, Inc. was that of Mr. Theodore Sharp of Korn Ferry, a management consulting firm. Like Mr. Kursh, Mr. Sharp also relied on a report prepared by his firm, and similar to the testimony provided by Mr. Kursh, Mr. Sharp displayed little knowledge about the data underlying the report. And as was the case with the BLDS report, the court similarly found that the assumptions behind the report were unsound. Therefore, the court also gave little or no weight to Mr. Sharp's testimony or the Korn Ferry report.

In response, the IRS presented expert testimony by Mr. David Fuller of the Firm Value, Inc., a company which routinely renders advice on executive compensation. Mr. Fuller presented two opinions of a reasonable salary for Mr. Hood. The "primary" opinion concluded that reasonable compensation for Mr. Hood was \$3,681,269 for 2015 and \$1,314,500 for 2016. The alternative opinion, which used different assumptions, presented substantially lower amounts for reasonable compensation: \$2,202,063 for 2015 and \$1,314,500 for 2016. Of three reports, the court found Mr. Fuller's testimony and report to be "the most credible and complete source of data, analysis and conclusions" and granted Clary Hood, Inc. a deduction based on Mr. Fuller's primary opinion, which was the higher of the two.

Penalties

As noted, the court waived substantial underpayment penalties for 2015 but not for 2016, finding that the taxpayer acted with reasonable cause and in good faith regarding the 2015 return. During that year, Clary Hood, Inc. had sought advice on Mr. Hood's compensation from its outside accounting firm, Elliot Davis, including having had discussions with an audit partner who was head of the firm's construction practice and with a tax partner having over twenty years of experience as a CPA and who had guided at least twenty other clients on similar compensation issues. The court determined that Clary Hood, Inc. provided necessary and accurate information about Mr. Hood's compensation to its outside accountants and found that the accountants carried out a reasonably critical analysis of the data provided. The court ruled that Clary Hood, Inc. relied in good faith on the judgment of their independent accounting advisors.

In contrast with 2015, Clary Hood, Inc. could provide no evidence of similar consultations for the 2016 tax year, other than preparation of an updated compensation spreadsheet by Clary Hood, Inc. personnel. Alternatively, Clary Hood, Inc. argued for exemption from penalty by claiming substantial authority for their position, citing the aforementioned independent investor approach supported by two decisions in the U.S. Court of Appeals for the Seventh Circuit. However, the tax court noted that only the Seventh Circuit has rejected the multi-factor

approach and that this case, if appealed, would go to the U.S. Court of Appeals for the Fourth Circuit. Thus, the tax court upheld the IRS's substantial underpayment penalty for 2016.

Conclusion

This case demonstrates that while there may be a great deal of leeway in what is considered reasonable executive compensation under Treasury regulations, there are also limits. In *Clary Hood, Inc. v. Commissioner*, the tax court stressed having sound, well-documented support for drastic increases in executive compensation. Compensation needs to be factually supported by comparables that are truly comparable, and these computations should be subject to ongoing review by advisors who are knowledgeable about both compensation issues as well as the taxpayer's particular circumstances.