Miller & Sons Drywall, Inc. v. Commissioner, T.C. Memo 2005-114, May 19, 2005

On January 6, 2003, the IRS issued a notice of Federal income tax deficiencies for petitioner's tax years ended June 30, 1998, 1999, and 2000, of $82,686, $83,016 and $103,855, respectively. The IRS claimed that these taxes were owed because compensation paid to its shareholder employees was unreasonable under Section 162(a).

The Facts: Miller & Sons Drywall ("the Company") began in the mid 1970's and was incorporated on July 1, 1980. From June 30, 1982, until June 30, 2000, it was owned by three brothers as follows: Darle Miller (51.8%), Dean Miller (24.1%) and Rocky Miller (24.1%). The Company operated as a drywall subcontractor. Darle Miller was the CEO and president of the Company. He performed many duties but was primarily responsible for determining the pricing for bids. Darle worked approximately 55 hours per week. Rocky was the vice president. He also performed many duties but was primarily responsible for job-site supervision. Rocky worked 55-60 hours per week. Dean was the secretary/treasurer. He was also a job-site supervisor with the same duties as Rocky. Dean also worked approximately 55-60 hours per week.

Compensation paid to Darle, Rocky and Dean for the years in question was as follows:

	1998			1999			2000		
	Base	Bonus	Total	Base	Bonus	Total	Base	Bonus	Total
Darle	300,000	0	300,000	282,501	0	282,501	300,000	140,000	440,000
Rocky	90,000	60,000	150,000	90,000	60,000	150,000	90,000	160,000	250,000
Dean	90,000	60,000	150,000	90,000	60,000	150,000	90,000	160,000	250,000

As of June 30, 2000, the Company had retained earnings of $781,702 and total shareholder equity of $793,002. The Company never declared a dividend.

The Arguments: Section 162(a)(1) permits a taxpayer to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." A taxpayer can take a deduction for compensation only if: (1) the payments were reasonable in amount, and (2) the payments were for services actually rendered. The Company argues that the total compensation paid to its shareholder-employees was deductible because it was reasonable under Section 162(a). The IRS argues that the compensation paid to the shareholder-employees was unreasonable and was, instead, disguised dividends.

The Findings: The Court assessed the following factors in its determination of the reasonableness of the compensation at issue:

- Employee Qualifications: The qualifications of an employee may justify high compensation for his services. The Court found that Darle's knowledge, experience and exceptional bid pricing warranted high compensation and that

Rocky and Dean's knowledge and experience also warranted high compensation. Accordingly, **the Court determined that this factor favored the Company**.

- Nature, Extent and Scope of An Employee's Work: An employee's position, duties performed, hours worked and general importance to the corporation's success may justify high compensation. The Court found that Darle's accurate job costing was extremely important to the Company's success and that his 20 years of bidding experience was irreplaceable to the Company. The Court also found that Rocky and Dean's job-site supervision experience helped jobs stay within budget and was instrumental in the Company's profitability. Furthermore, Rocky and Dean worked hours in excess of normal hours. Accordingly, **the Court determined that this factor favored the Company**.

- Size and Complexity of Company's Business: The size and complexity of a business is also an important consideration when deciding the reasonableness of compensation paid to its shareholder-employees. The Company was small and was not experiencing substantial growth. However, Darle testified that a substantial number of competitors had emerged and failed throughout the Company's existence. The Court determined that successful execution of a business model that would succeed in a highly competitive industry such as drywall contracting was complex. Accordingly, **the Court determined that this factor also favored the Company**.

- General Economic Conditions: The employee's impact on the business compared to the impact of the general economic conditions is also an important consideration. There were no records which indicate that any of the Company's shareholder-employees worked fewer hours because the economic conditions were favorable. The Court determined that economic conditions had, at most, a minimal impact on the Company's success. Accordingly, **the Court determined that this factor favored the Company**.

- Comparison of Salaries With Distributions to Stockholders and Retained Earnings: The Court of Appeals for the Eighth Circuit has stated that the absence of dividends to stockholders out of available profits may indicate that some of the compensation paid to shareholder-employees is actually a dividend. However, corporations generally are not required to pay dividends. Darle testified that the Company did not pay dividends because it wanted a financial cushion in case it had difficulty in obtaining jobs. The IRS said the Company's retained earnings were excessive and the Court disagreed. The independent investor test was also analyzed here. The independent investor test measures whether a company's shareholders received a fair return on their investment. The Court analyzed reasonable rates of return from both parties and concluded an average reasonable rate of return for the years at issue was 15.8%. Petitioner's ROE was 7.8%, (4.1%) and 41.3% for the years 1998 through 2000, respectively. The average ROE for the 3 years in issue was 15 percent, which is very close to the assumed reasonable rate of return of 15.8% (see above). Accordingly, **the Court determined that this factor favored the Company**.

- <u>Comparison of Compensation to Gross and Net Income:</u> Compensation as a percentage of a company's gross and net income has been considered in deciding whether compensation was reasonable. Compensation as a percentage of the Company's gross sales ranged from 32% to 35% and compensation as a percentage of income before taxes and officer compensation ranged from 74% to 108%. **The Court determined that these statistics were high and that this factor favored the IRS.**

- <u>External Comparison:</u> It is also important to compare shareholder-employee salaries to salaries that similar companies pay for similar employee services. In this case, salary surveys (ERI, RMA and NIBM) were used by both parties to determine Darle's compensation. The Court found the salary data provided by ERI, RMA and NIBM to be insufficient for a number of reasons and ultimately determined this factor favored neither party in determining Darle's compensation because both parties failed to provide persuasive comparable compensation data. Both parties relied on information from the Minnesota Work Force Center (MWFC) and determined that Rocky and Dean's job responsibilities were analogous to those of a construction manager. The Court determined that Dean and Rocky deserved to be compensated above the 90th percentile as found in the MWFC data and then this data needed to be productivity adjusted for the number of hours worked by Dean and Rocky. **Ultimately, the Court determined that this factor was neutral**.

- <u>Petitioner's Salary Policy as to all Employees:</u> Courts have considered the salary policy of a company to all its employees (looking for internal consistency) an important consideration in determining whether its shareholder-employees received reasonable compensation. The facts showed that the Company regularly paid bonuses to its shareholder employees and did not do the same for its non-shareholder-employees. Accordingly, **the Court determined that this factor favored the IRS**.

- <u>Petitioner's Pretax Profit Margin:</u> The Company claimed that its pretax profit margin before shareholder-employee compensation was high indicating it was exceptionally well managed. The IRS argued that petitioner's mean pretax profit margin was virtually identical to the industry average. The Court found that the Company had an exceptional pretax profit margin before shareholder-employee compensation for each tax year in issue—indicating that the shareholder-employees were deserving of high compensation. However, the Court also stated that the pretax profit margin after shareholder compensation was not exceptional, and the compensation paid to the Company's shareholder-employees depleted its earnings significantly. **The Court determined that this factor was neutral**.

After an assessment of the above nine factors, the Court determined that a preponderance of the evidence showed that the Company's shareholders were reasonably compensated for each year in issue (5 factors in favor of Company, 2 in favor of IRS and 2 Neutral). Accordingly, the Company was allowed to deduct in full the compensation paid each year.

Parting Thoughts:

I found this case to be extremely interesting because reasonable compensation is an issue addressed by business appraisers in most every valuation. I also chuckled at the fact that the Court did not find salary data from ERI, RMA or NIBM to be relevant data that could be relied upon (because accountants and appraisers commonly pay from $200 to $2,000 annually to obtain access to this data).