Making Science of Art: Unreasonable Compensation and Judge Posner’s Independent Investor Test in Exacto Spring

Introduction

The Internal Revenue Code has long been beset by the problem of unreasonable compensation. Where the executive employee of a corporation is also the owner, there is a temptation for him to distribute the corporation’s earnings to himself in the form of a salary, thereby evading double-taxation of corporate profits. Section 162 of the Code addresses this problem by limiting salaries to amounts that are “reasonable”; predictably, the word “reasonable” has defied simple interpretation. In an effort to define “reasonable” for section 162 purposes, courts have developed various multi-factor tests for use in unreasonable compensation cases. Courts disagree, however, as to the number of factors to be considered in the multi-factor analysis, and there is no consensus on the relative weight of each factor. Unreasonable compensation cases thus inevitably dissolve into subjective determinations by the courts. Indeed, one court has confessed that the determination of reasonable compensation under the multi-factor tests is “more nearly an art than a science.”[1]

In Exacto Spring v. Commissioner,[2] Judge Posner gives a devastating criticism of the multi-factor tests, and in their place proposes a new test – the independent investor test. This new test defines reasonable compensation in relation to the rate of return the executive employee generates on the corporations’ assets. By tying executive compensation to the corporation’s rate of return – an amount that can be objectively calculated – the independent investor test avoids the subjectivity which plagues the multi-factor analysis. Post-Exacto decisions indicate widespread agreement with Judge Posner’s criticisms of the multi-factor analysis, but they also show some confusion as to the proper application of his independent investor test. Indeed, the
independent investor test conceals some very difficult valuation issues which, because of the facts stipulated in the *Exacto Spring* case, Judge Posner never had to explicitly address.

This paper will attempt to flesh out the independent investor test by addressing the valuation issues Judge Posner was able to avoid. Part I will discuss the problem of unreasonable compensation and how the multi-factor tests attempt to address it. Part II will examine Judge Posner’s criticisms of the multi-factor tests and his proposed independent investor test in *Exacto Spring*. Part III will explore the valuation issues inherent in the independent investor test, and suggest how subsequent courts should go about applying the test to unreasonable compensation cases.

I. Unreasonable Compensation and the Multi-factor Tests

Unreasonable compensation issues arise in the context of sole-shareholder C corporations ("C corps").[3] Under the Internal Rule Code, C corps are considered taxable entities separate from their shareholders. The earnings of C corps are thus subject to two levels of tax – first at the entity level when the income is earned by the corporation, and then again at the shareholder level when the corporation distributes those earnings. The burden of this double taxation is most obvious in the case of sole-shareholder C corps; although, for tax purposes, there are two separate entities – the C corp and the shareholder – each receiving taxable income, in actuality there is only one person – the shareholder – doing the income-producing work.

The burden of double taxation will be greater or less depending on how the C corp’s earnings are distributed to the shareholder. Essentially, the shareholder can get the earnings out of the corporation in one of two different ways.[4] First, she can make the corporation distribute
its earnings in the form of a dividend. In most cases, dividends will bear the full brunt of double taxation – the earnings, which have already been taxed at the entity at the entity level when earned, are taxed again at the shareholder level when distributed.[5] Second, if the shareholder is also an employee of the corporation, she can make the corporation pay her a salary. Generally speaking, salary paid to the shareholder will escape double taxation – the salary will be taxed to the shareholder when earned, but the corporation is allowed a deduction on its tax return for the salary paid.[6] Because of salary’s more favorable tax treatment, the shareholder naturally has an incentive to disguise all distributions from the corporation as salary.

Recognizing the shareholder’s incentive to disguise dividends as salary, the Code attempts to limit the amount of salary that the C corp can deduct. Section 162 limits the deduction to “a reasonable allowance for salaries or other compensation for personal services actually rendered.”[7] Two limitations are apparent in that provision. First, the C corp can deduct salaries only if they are in compensation for services “actually rendered.” In other words, the shareholder must actually do some kind of work in order for his salary to be deductible by the C corp. Second, the C corp can deduct salaries only to the extent they are “reasonable” in amount. The term “reasonable,” however, is defined neither by the Code nor by regulations.[8] It is this second limitation, therefore, that causes the most uncertainty and litigation.

In an effort to resolve the many unreasonable compensation challenges brought by the Internal Revenue Service (“the Service”), courts have developed various multi-factor tests to determine the reasonableness of salary deductions claimed by C corps. The precise formulation of the test varies from court to court and even from case to case. Some versions of the test
consist of as few as five factors;[9] at least one version consists of as many as twenty-one.[10] One of the most commonly cited versions of the test, however, consist of the following nine factors:

1) the employee’s qualifications; 2) the nature and scope of the employee’s work; 3) the size and complexities of the business; 4) a comparison of salaries paid with the gross income and net income; 5) the prevailing general economic conditions; 6) comparison of salaries with distributions to stockholders; 7) the prevailing rates of compensation for comparable positions in comparable concerns; 8) the salary policy of the taxpayer as to all employees; and 9) in the case of small corporations with a limited number of officers the amount of compensations paid to the particular employee in previous years.[11]

Not all of these factors, of course, are relevant in every case, and no one factor is determinative. The resolution of any individual case depends on the specific facts and circumstances.[12]

II. *Exacto Spring*: Death of Multi-Factor Test and Rise of the Independent Investor

The traditional multi-factor tests came under fire by Judge Posner in *Exacto Spring*. The taxpayer in that case, Exacto Spring Corporation, was a closely-held C corporation that manufactured precision springs.[14] In 1993 and 1994, it paid William Heitz – its cofounder, CEO and principal owner – a salary of $1.3 million and $1 million, and claimed deductions for these amounts on its tax returns for the respective taxable years.[15] The Service, considering these amounts excessive, determined that Heitz should not have been paid more than $381,000 in 1993 and $400,000 in 1994.[16] It added the difference between the claimed deductions and its determinations to Exacto’s income for the appropriate years and assessed deficiencies accordingly.[17] When Exacto challenged the assessments in Tax Court, the court applied a version of the multi-factor test that consisted of seven factors.[18] After briefly considering each of these factors, it ruled that six of them favored Exacto. Then, with little
numerical analysis, the court held that the maximum reasonable compensation for Heitz would have been $900,000 in 1993 and $700,000 in 1994 – figures that just happened to be about halfway between the claimed deductions and the Service’s determinations.[19] Heitz appealed the decision to the Seventh Circuit.[20]

In overturning the Tax Court’s ruling, Judge Posner began by criticizing that court’s very use of a multi-factor test. Posner had several gripes with the multi-factor analysis. His first criticism was that such analysis is “nondirective” in that it gives “no indication . . . of how the factors are to be weighed in the event they don’t all line up on one side.”[21] Furthermore, “because of its nondirective character, it invites the making of arbitrary decisions based on uncanalized discretion or unprincipled rules of thumb.”[22] In fact, he pointed out, the Tax Court’s ruling was a prime example of exactly that. In determining what amount of compensation would have been reasonable, the Tax Court seems to have just picked a number about halfway between the Service’s determination and Exacto’s claimed deductions.[23] In Judge Posner’s words, “[i]t cut the baby in half. One would have to be awfully naïve to believe that the seven-factor test generated this pleasing symmetry.”[24]

The Tax Court’s ruling is not the only example of the seemingly arbitrary decision-making encouraged by the multi-factor analysis. The cases of Denison Poultry and Egg Co. v. U.S.[25] and Clymer, Jr. v. Commissioner[26] provide an even more striking illustration of the multi-factor test’s “nondirective character.” Both cases concerned virtually identical factual scenarios. The taxpayer in both cases was Denison Poultry, a sole-shareholder C corp owned and operated by its CEO and president Ray Clymer, Jr. Both cases, though focusing on different taxable years, decided the reasonableness of deductions claimed by Denison Poultry for salary
paid to Clymer pursuant to the same compensation agreement. The salary paid to Clymer was roughly the same in both cases, as were the extent and nature of his services, the earnings of the business, and the general economic conditions. The only notable factual difference between the two cases was that in Denison, the C corp paid Clymer a dividend in addition to his salary.

The courts in both cases employed the same nine-factor test to determine the reasonableness of Clymer’s salary. They both ran through each of the factors and found that all of them favored Dension except one; the comparable salaries factor was neutral because the courts disagreed with both Denison’s and the Service’s methods of comparison. Despite virtually identical legal tests and factual scenarios, however, the two courts came to shockingly different conclusions. In Denison, the federal district court held that “the compensation paid Clymer during 1977 was reasonable within the meaning of section 162(a)(i).”[27] The tax court in Clymer, by contrast, held that although “a reasonable compensation for Clymer’s services to Denison exceeds the amounts allowed by the [Service]”, the proper amount was something less than what was deducted by Denison.[28] The court then, much like the court in Heinz, settled on an amount roughly midway between the two figures.[29] In neither Denison nor Clymer was there any numerical analysis. Both courts, lacking guidance from the “nondirective” multi-factor test, seem to have made arbitrary decisions, just like Judge Posner observed.

Another of Posner’s criticisms of the multi-factor analysis is that it “invites the Tax Court to set itself up as a superpersonnel department for closely held corporations, a role unsuitable for courts.”[30] In making this criticism, Posner draws parallels to Title VII discrimination claims. In Title VII cases, courts do not dictate employer hiring policies; rather they try to determine whether the employer’s hiring policies conceal discriminatory intent.[31] Likewise in
unreasonable compensation cases, courts should not dictate employee compensation agreements; rather they should try to determine whether a shareholder’s salary was intended as a concealed divided payment. If they determine that the purported salary does conceal a dividend payment, they need to separate out the compensation portion from the dividend portion. The multi-factor tests, however, do not enable courts to make these determinations. Instead, they encourage courts “to decide what the taxpayer's employees should be paid on the basis of the judges' own ideas of what jobs are comparable, what relation an employee's salary should bear to the corporation's net earnings, what types of business should pay abnormally high (or low) salaries, and so forth.”[32] As Judge Posner himself notes, however, judges “are not equipped by training or experience to determine the salaries of corporate officers.”[33]

Posner’s final criticism of the multi-factor tests is that “because the reaction of the Tax Court to a challenge to the deduction of executive compensation is unpredictable, corporations run unavoidable legal risks in determining a level of compensation that may be indispensable to the success of their business.”[34] Because courts are not consistent as to how they weigh the various factors, or even as to what factors they consider, it is difficult for C corps to set shareholder salaries such a way that they comply with the law. Furthermore, because every unreasonable compensation case is so fact-dependant, prior court decision are of little precedential value; indeed, as the cases of Denison and Clymer make clear, even identical facts under identical legal tests can lead to differing results. Uncertainty in this area of the law leads to litigation and inefficiency in business.[35]

To avoid all the shortcomings of the multi-factor tests, Judge Posner urged the Seventh Circuit to adopt a new test – the independent investor test. Under the independent investor test,
A corporation can be conceptualized as a contract in which the owner of assets hires a person to manage them. The owner pays the manager a salary and in exchange the manager works to increase the value of the assets that have been entrusted to his management; that increase can be expressed as a rate of return to the owner's investment. The higher the rate of return (adjusted for risk) that a manager can generate, the greater the salary he can command. If the rate of return is extremely high, it will be difficult to prove that the manager is being overpaid, for it will be implausible that if he quit if his salary was cut, and he was replaced by a lower-paid manager, the owner would be better off; it would be killing the goose that lays the golden egg.[36]

The advantage of this test, according to Posner, is that it approximates the results of publicly held companies. In publicly held companies, where an independent board of directors fixes executive salaries, “the danger of siphoning corporate earnings to executives in the form of salaries is not acute.”[37] Unless the board lacks independence or a good-faith concern for the corporate welfare, it presumably sets compensation based on economic or market-related factors; the business judgment rule bars judges from second-guessing the board’s decision.[38] In sole-shareholder C corps, however, where the same individual is the executive and the board, she has both the opportunity and the incentive to disguise dividends as salary. By tying the salary to some market rate of return, the independent investor test simulates the economic-based decisions of an independent board of directors. It also simulates the business judgment rule by taking the determination of executive salaries out the sole discretion of judges who “are not competent to decide what business executives are worth.”[39]

As Posner himself indicates, the independent investor test he proposes is not an entirely new idea. In an earlier case, Elliotts, Inc. v. Commissioner,[40] the Ninth Circuit first articulated something like Posner’s independent investor test. Elliotts involved an appeal from a Tax Court decision which held that simply because the sole shareholder was drawing a salary from the C corp, the salary must necessarily contain disguised dividends.[41] In reversing and remanding
the decision, the Ninth Circuit reminded Tax Court that there were “many factors to be considered.”[42] According to the court, one relevant inquiry is

whether an inactive, independent investor would be willing to compensate the employee as he was compensated. The nature and quality of the services should be considered, as well as the effect of those services on the return the investor is seeing on his investment. The corporation's rate of return on equity would be relevant to the independent investor in assessing the reasonableness of compensation in a small corporation where excessive compensation would noticeably decrease the rate of return.[43]

The court in *Elliotts*, however, treated the “hypothetical independent investor” as just one more factor to consider when applying the multi-factor test. It did not suggest that the multi-factor should be abandoned.

The Second Circuit went a step further than the Ninth in the cases of *Rapco, Inc. v. Commissioner*[44] and *Dexsil Corp. v. Commissioner*. The court in *Rapco* stated that when applying the multi-factor test, the independent investor should not be treated as just another factor, but rather “the court should assess the entire tableau from the perspective of an independent investor -- that is, given the dividends and return on equity enjoyed by a disinterested stockholder, would that stockholder approve the compensation paid to the employee?”[46] In spite of that language, the court in *Rapco* ruled against the taxpayer even though it had “a substantial return on equity.”[47] It held that “return on equity is only one factor,” and “[n]o one factor is dispositive.”[48] The *Dexsil* case expanded on this idea by explaining that

in this circuit the independent investor test is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed. Thus, if the company's earnings on equity, when viewed in relation to such factors as the company's overall performance and levels of compensation, “remain at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company disguised as salary.”[49]
Although the Second Circuit in *Dexsil* was still ostensibly operating under the multi-factor analysis, it put much more weight on the independent investor analysis than it did in the earlier *Rapco*. Indeed, it remanded the case to the Tax Court, finding its “failure to assess the reasonableness of [the taxpayer’s] compensation from the perspective of a hypothetical or independent investor erroneous as a matter of law.”[50]

Whereas *Elliott*, *Rapco* and *Dexsil* represent refinements of the multi-factor analysis of unreasonable compensation, *Exacto* signifies a clean break. After *Exacto*, the independent investor test is no longer just another “nondirective” factor; it is neither the “perspective” from which courts assess the “entire tableau,” nor the “lens” through which all the other factors are viewed. Those formulations, Judge Posner suggests, are the result of “judges tend[ing] to downplay the element of judicial creativity in adapting law to fresh insights and changed circumstances.”[51] Rather, the independent investor test becomes the entire analysis; it becomes a “new test [that] dissolves the old and returns the inquiry to basics.”[52]

**III. Application of the Independent Investor Test**

Although, on its surface, Posner’s independent investor test appears to be a much simpler alternative to the traditional multi-factor test, it conceals some very difficult valuation issues. The independent investor test ties the sole-shareholder’s salary to the rate of return he generates on the C corps assets. Thus, in order to assess the reasonableness of the salary, courts must 1) determine the current value of the C corp – that is, what is the C corp worth now?; 2) identify the measurement period – that is, in order to calculate the rate of return, the current of the C corp must be compared to its value at some earlier point in time, but what point in time is that?; 3) identify an acceptable rate of return – that is, what rate of return would independent
investor justifiably expect the shareholder to generate?; and 4) recalculate the shareholder’s salary if it is found to be unreasonable – that is, if the shareholder’s claimed salary is unreasonable, what amount is reasonable?

Judge Posner never had to grapple with these issues because, in *Exacto*, the parties had stipulated to both the actual rate of return and the acceptable rate of return.[53] Posner did suggest that the valuation method they used was odd,[54] but concluded that because “no one in the case questions it we shall not make an issue of it.”[55] Of course, had the parties known that the independent investor test would become the sole inquiry, they likely would have “made an issue of it.” By accepting stipulations to issues the parties did not think were material until after the *Exacto* decision, Posner conveniently avoided all the difficult valuation issues raised by his independent investor test.

1. Determining the Current Value of the Corporations

Perhaps due to the lack of direction provided by *Exacto*, subsequent courts have struggled with how to calculate the rate of return. Many post-*Exacto* cases calculate rate return as a percentage of the C corp’s after-tax income over the total of the yearend balances in its capital stock, paid-in surplus and retained earnings accounts (in other words, the owner’s equity portion of a balance sheet).[56] This is a very simple way to calculate return on equity, especially because both income and owner’s equity are reported on the corporate tax return and thus readily available for the Service and the court to use. The problem with this calculation, however, is that it is a too simplistic. It does not take into account appreciation of the C corp’s assets, especially intangible assets such as trademarks and goodwill. To account for appreciation in assets, some other way of calculating rate of return is needed.
To calculate a rate of return that reflects appreciation in corporate assets, it is necessary to first determine the current fair market value of the corporation, and then to compare its current value to its value at some relevant time in the past. By subtracting the current value from the past value, and then dividing the difference by the past value, the appraiser will arrive at the rate of return expressed as a percentage. Of course, in the case of closely-held corporations, determining the fair market value of the corporation can be very difficult. Unlike publicly held corporations, there is no established market for shares of a closely held corporation which could provide a basis for determining the value of the corporation as a whole. Thus, in order for the independent investor test to work, courts need some guidance as to how calculate the fair market value of closely-held corporations.

Luckily, valuation guidance already exists elsewhere in the Code. Courts must often valuate closely-held corporations for gift and estate tax purposes. To assist them in these tasks, regulations 20.2031-1(b) and 25.2512-1, and Revenue Ruling 59-60 describe a number of acceptable valuation methods. Four of the most commonly used methods are 1) the book value approach; 2) the earnings approach; 3) the dividend approach; and 4) the market approach. Because these valuation methods are authorized by the Code and commonly applied by the courts, it is only natural that they be applied to the unreasonable compensation context.

Under the book value method, the appraiser takes the historical cost of all the corporation’s assets, and then subtracts amortization, depreciation and all liabilities; the resulting figure is the corporation’s book value. Although this method is simplest, it fails to take into account appreciation of assets such as land or goodwill and other intangibles. Under the earnings
approach, the appraiser uses the corporation’s current financial status to project its future earnings, and then discounts those projected earnings back to present value; the resulting figure represents what a potential buyer would presently pay for a future stream of income which he expects the investment to generate. Under the dividend approach, the appraiser reviews the history of the corporation’s dividend payments and dividend-paying capacity, and then capitalizes that factor based on dividend yields of comparable public companies. This difficulty of this method is that it depends on many different variables, such as the corporation’s current need for capital and its future expected needs. Under the market approach, the appraiser determines the value of the corporation by comparing it to similarly-situated corporations whose value is already known. The disadvantage of this it requires subjective comparisons between different corporations.

Obviously, the nature of the corporation and its assets will determine which method is appropriate in any given case. And surely, the taxpayer and the Service will disagree as to which method is more accurate. To help courts determine the relative appropriateness of each method, Revenue Ruling 59-60 lists eight factors for court to consider. These factors are:

1) the nature of the business and the history of the enterprise from its inception; 2) the economic outlook in general and the condition and outlook of the specific industry in particular; 3) the book value of the stock and the financial condition of the business; 4) the earning capacity of the company; 5) the dividend-paying capacity; 6) whether or not the enterprise has goodwill or other intangible value; 7) sales of the stock and the size of the block of stock to be valued; 8) the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Although it may seem ridiculous to abandon the traditional multi-factor analysis only to replace it with another analysis which involves another multi-factor test, the factors involved in the valuation process will lead to much more objective and accurate results. First of all, the
valuation process will limit the scope of the judge’s discretion in that it will require the testimony of expert appraisers. Secondly, to the extent that judge exercises his discretion in choosing the more appropriate method, her attention will be focused on more numerical calculations.

2. Identifying the Measurement Period

The post-Exacto cases also show some confusion as to the appropriate measurement period to be used in evaluating the rate of return. To measure the rate of return, the appraiser, after determining the current fair market value of the corporation, must then compare that to the value of the corporation at some time in the past. In the case of a sole-shareholder C corp, the relevant past value should presumably be the shareholder’s initial capital contribution. The court in Normandie Metal Fabricators, Inc. v. Commissioner,[60] however, disagreed with that approach. That court ruled that it would be misleading to measure return on equity based on a shareholder’s nominal initial investment because the shareholder might have contributed “sweat equity” or other intangibles that did not appear on the balance sheet.[61] Thus, instead of calculating rate of return using the shareholder’s initial investment, it considered only the taxable years under audit in the case.[62]

The concerns in Normandie seem to be misguided. After all, although sweat equity and other intangibles do not appear on the balance sheet, their existence does not somehow distort on the rate of return analysis. Furthermore, if the court refuses to consider the shareholder’s entire holding period when calculating the rate of return, it may disallow salary deductions for years in which such compensation was in fact reasonable. For example, even in individual years where the C corp shows a negative rate of return, the shareholder would presumably be entitled to some amount of salary. If the court considered only that individual taxable year, it would find any
amount of salary to be unreasonable. By considering the shareholder’s entire holding period, however, it can calculate an average annual rate of return. Using this rate of return, the court would rightfully allow deductions for shareholder compensation even in down years.

3. Identifying an Acceptable Rate of Return

After valuating the C corp and determining the rate of return, the court must then compare that rate of return to a rate that an independent investor would find acceptable. What an independent investor would find acceptable depends on the relative amount of risk involved in the investment. The relative amount of risk will of course vary from business to business, and the acceptable rate of return will vary accordingly. Clearly, however, the lower end of the acceptable rate should be fixed by the rate yielded by a 10-year Treasury bond. Treasury bonds are the most conservative investments available because there is virtually no risk that the United States federal government will default on those obligations. Currently, the 10-year Treasury bond rate stands at 5.38%.[63]

Because equity investments are inherently more risky than government bonds, an independent investor in a small corporation would demand more than a 5.38% rate of return. For purposes of the independent investor test, therefore, the acceptable rate of return should therefore be adjusted upward to account for the additional risk of corporate investment. Large publicly-held corporations currently yield an average rate of return of about 5% more than a 10-year Treasury bond.[64] Because large publicly-held corporations are the most conservative form of equity investment, the acceptable rate of return should be at increased by at least that amount.
Investing in a single-shareholder C corp is inevitably more risky than buying stock in publicly-held corporation, and so the acceptable rate of return should be adjusted further upward. When investing in small closely-held companies, investors generally require an additional 1%-10% over the public company rate of return. Within that range, however, financial experts disagree over how exactly the rate should be calculated.[65] Despite that uncertainty, however, determining the rate of return is a highly objective calculation. Although judges must use their discretion when determining exactly how much higher the acceptable rate of return would be for a given C corp, the high and low ends of the range are fixed by the market – essentially, an acceptable rate of return is between 10%-20%.[66] Because this range is determined by the market, the independent investor test avoids the subjectivity of the multi-factor tests.

4. The Presumptive Nature of the Test and Recalculating a Reasonable Amount

The *Exacto* case also leaves unanswered questions about the presumptive nature of the independent investor test. According to Judge Posner,

When, notwithstanding the CEO's "exorbitant" salary (as it might appear to a judge or other modestly paid official), the investors in his company are obtaining a far higher return than they had any reason to expect, his salary is presumptively reasonable.[67]

The presumption can be rebutted, he suggests, in situations where “the return, though very high, is not due to the CEO's exertions.”[68] A prime example of such a rebutting circumstance is where the increase in value of the C corp is due to the sudden discovery of oil under a parcel of land previously considered worthless.[69]
At least one post-Exacto case deals with the presumptive nature of independent investor test in a questionable manner. The case of Menard, Inc. v. Commissioner involved a C corp that claimed deductions for a large salary paid to the majority shareholder and CEO, Mr. Menard.[70] The court found that although “rate of return . . . generated by the taxpayer corporation . . . is sufficient to create a rebuttable presumption that the compensation paid . . . is reasonable,” the presumption was rebutted by the fact that salary paid “substantially exceeded the compensation paid to comparable publicly traded corporations to their CEOs.”[71] It then recalculated Mr. Menard’s compensation based on those comparable salaries.[72]

It is unclear why the salaries paid to comparable executives in comparable corporations should even be relevant to the independent investor analysis. After all, the salary paid to executives in other companies has nothing at all to do with whether the rate of return in the C corp under consideration is “due to the CEO’s exertions.” Furthermore, by using comparable salaries as rebutting circumstance, the court undermines the independent investor test and reintroduces the subjectivity of the multi-factor analysis. After finding the shareholder’s compensation unreasonable, the court is again put in the position of determining the proper amount of compensation, the very task Posner says judges “are not competent to find.”

Although not exactly spelled out in the Exacto case, the readjustment of the compensation under the independent investor test should presumably occur as follows. The court will take the actual rate of return generated by the corporation and then compare that rate to the acceptable rate of return. If the actual rate of return is less than the acceptable rate, or if the actual rate exceeds the acceptable rate but was not due to the shareholder’s efforts, the shareholder’s salary is unreasonable. The court will then reduce the shareholder’s salary, adding it back to the
corporation’s retaining earnings account, until the corporation’s rate of return, as recalculated, equals the acceptable rate of return. This approach is objective and is far superior to the multi-factor test method of recalculation, where the court just picks the number in between the figures provided by the Service and the taxpayer.

**Conclusion**

Few people would challenge Judge Posner’s criticisms of the multi-factor tests of determining reasonable compensation under Section 162 of the Code. His discrediting of the multi-factor analysis is convincing and complete, and analysis of courts decisions which employ the multi-factor tests supports his assessments. In place of the multi-factor tests, he makes a very eloquent proposal in favor of an independent investor test of determining reasonable compensation. This new test is not quite as simple as the *Exacto* decision suggests. The parties in *Exacto* were in agreement as to the rate of return generated on the corporation’s assets, as well what an acceptable market rate of return would be. After *Exacto*, however, the corporation’s rate of return has become the central inquiry in unreasonable compensation cases. It is thus highly unlikely that rate of return issues will be stipulated in future unreasonable compensation cases.

This paper has attempted to flesh out how Judge Posner’s independent investor test should be applied when the corporation’s rate of return is in dispute. Although the application of the test involves some difficult valuation issues, it forces courts to focus their attention on relevant, objective data to determine the reasonableness of compensation. The valuation methods may be unfamiliar in the reasonable compensation context, but the courts have proven experience and aptitude in such methods from other areas of taxation. Moreover, because the test speaks the language of investment and finance, it should be more comprehensible to the
average corporate business owner. By making the inquiry more objective and comprehensible, the independent investor test should improve compliance and reduce controversy. Thus now, under the independent investor test, determinations of unreasonable compensation may be considered more nearly a science than an art.


[3] Many of these same issues arise in the context of closely-held C corporations as well. In order to not to be distracted by issues of shareholders’ liability to each other, however, this paper will focus on the sole-shareholder situation. Also note that unreasonable compensation is not an issue for S corps, because they receive flow-thru tax treatment.

[4] Technically, are two additional ways for the shareholder to access his earnings – he can also sell his stock and redeem his stock. For sole shareholders, however, selling the stock is an unrealistic option. First, they are often unwilling to dilute their ownership in the corporation; second, even if they were willing, they would likely have difficulty finding a willing buyer because there is no public market for the stock. Although the sole shareholder could also technically redeem his stock, the Code would treat that as a dividend because there would be no reduction in percentage ownership of the corporation’s stock. See I.R.C. § 302.

[5] The tax treatment of dividends depends on the earnings are profits of the corporation. In most cases, this will result in the tax treatment described above. See I.R.C. § 301.


[7] Id. Note that compensation deductions for salaries paid to executives of publicly-held corporations are limited by a separate provision in section 162. Section 162(m) provides that “[i]n the case of any publicly-held corporation, no deduction shall be allowed . . . for applicable employee remuneration . . . to the extent the amount of such remuneration . . . exceeds $1,000,000.” Despite that seemingly strict limitation, the provision is rendered toothless by exceptions for broad categories of compensation, most notably for commissions and other performance-based compensation. See § 162(m)(4).

[9] Elliotts, Inc. v. Comm’r, 716 F.2d 1241 (9th Cir. 1983) (listing the relevant factors as 1) employee’s role in the company; 2) salaries paid in similar companies for similar services; 3) character and condition of the company; 4) conflict of interest between the corporation and the employee; and 5) salaries paid to other employees in the corporation).

[10] Foos v. Comm’r, T.C. Memo 1981-61 (1981) (listing the relevant factors as 1) employee's qualifications and training; 2) nature, extent, and scope of his duties; 3) responsibilities and hours involved; 4) size and complexity of the business; 5) results of the employee's efforts; 6) prevailing rates for comparable employees in comparable business; 7) scarcity of other qualified employees; 8) ratio of compensation to gross and net income (before salaries and federal income tax) of the business; 9) salary policy of the employer to its other employees; 10) amount of compensation paid to the employee in prior years; 11) employee's responsibility for employer's inception and/or success; 12) time of year the compensation was determined; 13) whether compensation was set by corporate directors; 14) correlation between the stockholder-employees' compensation and his stockholdings; 15) corporate dividend history; 16) contingent compensation formulas agreed on prior to the rendition of services and based upon a free bargain between the employer and employee; 17) under-compensation in prior years; 18) compensation paid in accordance with a plan which has been consistently followed; 19) prevailing economic conditions; 20) whether payments were meant as an inducement to remain with the employer; and 21) examination of the financial condition of the company after payment of compensation).


[13] 196 F.3d 833 (7th Cir. 1999)

[14] Id. at 834.

[15] Id.

[16] Id.

[17] Id. (listing the factors as 1) the type and extent of the services rendered; 2) the scarcity of qualified employees; 3) the qualifications and prior earning capacity of the employee; 4) the contributions of the employee to the business venture; 5) the net earnings of the employer; 6) the prevailing compensation paid to employees with comparable jobs; and 7) the peculiar characteristics of the employer's business).

[18] Id.

[19] Id.

[20] Id.

[21] Id. at 835.

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[29] Id.


See, e.g., Jackson v. E.J. Brach Corp., 176 F.3d 971, 984 (7th Cir. 1999).

[32] 196 F.3d at 835.

[33] Id.

[34] Id.

A report conducted by the General Accounting Office in 1995 shows that unreasonable compensation is the second-most litigated tax issue involving small corporations, second only to inadequate documentation issues. Unreasonable compensation issues comprise 35% of all petitions filed in the Tax Court by small corporations; inadequate documentation issues comprise 36%. See GAO, TAX ADMINISTRATION: RECURRING ISSUES IN TAX DISPUTES OVER BUSINESS EXPENSE DEDUCTION (1995)

[36] Id. at 838.

[37] Id.

See, e.g., Gagliardi v. TriFoods Int’l, Inc. 683 A.2d 1049, 1051 (Del. Ch. 1996).

[38] 196 F.3d at 838.

[39] 716 F.2d 1241 (9th Cir. 1983).

[40] Id. at 1242.

[41] Id. at 1248-9.
Exactly Spring’s rate of return was calculated by dividing its after-tax income by the balance in its owner’s equity account. As the next paragraph explains, this is an overly simplistic way of calculating rate of return.

When a taxpayer inherits a corporation, for example, he takes as his basis the fair market value of the corporation at the time of his benefactor’s death. Thus, in order to determine the taxpayer’s basis, the court must valuate the corporation.

In light of the uncertainty as to how courts will valuate corporations post-Exacto, one practitioner advises other attorneys to be aware that courts might resort these methods. William Benard, The Unreasonable Compensation Issue Rises from the Dead and Takes on the Independent Investor, 93 J. TAX’N 356 (2000).

Assume, for example, a court is trying to determine whether a salary of $20,000 is reasonable. Five years ago, the employee-shareholder made an initial and only investment of $60,000 in a C corp that is now worth $100,000. This is a total increase in value of $40,000 over 5 years, representing an average annual rate of return of 13.3% ($40,000 ÷ 5 years = $8,000 per year; $8,000 ÷ $60,000 = 13.3%). The court determined the acceptable rate of return would have been 15%. Because the actual rate of return is less than the acceptable rate of return, the salary is unreasonable and must be reduced. Reducing the salary by $5,000 and adding that amount back into the C corp’s net worth will result in an actual return equal to the acceptable rate of return ($105,000 - $60,000 = $45,000 total increase; $45,000 ÷ 5 years = $9,000 per year; $9,000 per year ÷ $60,000 = 15%). Thus, the maximum reasonable salary would be $15,000 ($20,000 - $5,000). $5,000 of the corporation’s claimed salary deduction is excessive and must be denied.