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Courts Don't Follow: Reasonable Compensation Rulings and the *Exacto Spring* Approach

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INTRODUCTION

The "reasonable compensation" issue is among the most frequently litigated tax issues.[1] Its genesis is the Internal Revenue Service's ("Service") concern that, to avoid double taxation, closely-held corporations may unreasonably increase salaries to shareholder-employees rather than distributing dividends to them.[2] The relevant statute, section 162 of the Internal Revenue Code ("Code"), allows taxpayers to deduct "ordinary and necessary expenses . . . including . . . a reasonable allowance for salaries or other compensation for personal services actually rendered."[3] Regulation 1.162-7(a) provides that deductible compensation payments must be both "reasonable" ("amount" test)[4] and "purely for services" ("intent" test).[5]

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1 Andrew W. Stumpff, *The Reasonable Compensation Rule*, 19 VA. TAX REV. 371, 372 n.4 (1999).

2 Lawrence R. Duthler, *The Independent Investor Test: The Latest Test in the Search for Reasonable Compensation is Blurred in the Second Circuit*, 45 WAYNE L. REV. 1953, 1955–56 (2000). The issue of whether a payment represents deductible compensation (as opposed to, for example, a disguised nondeductible dividend) generally only arises when an employee is also an owner. *Id.* at 1955. Currently, the federal corporate income tax rate varies between 15% and 39%, while the maximum individual rate is 35% for ordinary income and 15% for dividends. If a payment is treated as dividend rather than compensation, the shareholder saving of 20% (35% – 15%) offsets somewhat the corporate loss of 15% to 39%. For corporations with taxable income between $335,000 and $10 million, the marginal rate is 34%. For such corporations in tandem with their officers, the amount at issue is 14% (34% – 20%) of disputed compensation. Thus, even though dividends are tax-favored at the individual level, compensation is still generally advantageous for a corporation and officer in tandem. Melanie G. McCoskey, *Reasonable Compensation: Do You Know Where Your Circuit Stands?*, 109 J. TAX'N 228, 228 (2008).

3 I.R.C. § 162(a)(1) (2006).

4 Anne E. Moran, *Reasonable Compensation*, *in* TAX MANAGEMENT A-1, A-3 (Bureau of National Affairs, Portfolios Ser. No. 390-5th, 2011). Courts rarely focus on the intent

The "amount" test is the usual battleground between taxpayers and the Service.[6] Relevant thereto, Regulation 1.162-7(b)(3) prescribes "[i]n any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances" and "[i]t is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."[7]

Prior to *Exacto Spring*[8] in 1999, courts generally used a "facts and circumstances" test with multiple objective factors to determine the amount of reasonable compensation, an approach consonant with section 162 and its regulations.[9] In *Exacto Spring*, the Seventh Circuit alludes to the section 162 regulations only with respect to the "intent" test; and the court harshly criticizes the multiple objective factors analysis used by the Tax Court with respect to the "amount" test.[10] The Seventh Circuit then turns to economic theory, opining that if a given amount of compensation leaves return on equity sufficient to satisfy an independent investor, then it is presumptively reasonable.[11]

We believe *Exacto Spring* represents a legally improper and practically unwise departure from other reasonable compensation jurisprudence. Below, we first explain that *Exacto Spring* overstates the judicial trend regarding use of an independent investor perspective and return on equity in reasonable compensation cases. We then discuss *Exacto Spring* and other courts' reluctance to follow its approach. We then explicate the opinion's (1) inconsonance with section 162, its regulations, and its other case law, (2) questionable behavioral assumptions, and (3) creation of more fodder for confusion than

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test. *Id.*; McCoskey, *supra* note 2, at 228. Recently, courts have explicitly relied on the intent test in only two situations: (1) when a taxpayer attempts to re-characterize a payment as compensation, and (2) when a payment's characterization as compensation does not comport with its substance. Moran, *supra*.

5 Treas. Reg. § 1.162-7(a) (2011); Moran, *supra* note 4, at A-3. Hereafter, unless otherwise indicated, reasonable compensation refers to the *amount* of reasonable compensation.

6 McCoskey, *supra* note 2, at 228–29.

7 Treas. Reg. § 1.162-7(b)(3) (2011). Unlike regulations relating to some factual issues (for example, I.R.C. § 183 regulations), the I.R.C. § 162 regulations do not list specific factors courts should use to determine reasonable compensation. Treas. Reg. §§ 1.183-2(b), 1.162 (2011).

8 Exacto Spring Corp. v. Comm'r, 196 F.3d 833 (7th Cir. 1999). Unless otherwise indicated, references herein to *Exacto Spring* are to the Seventh Circuit opinion. Hereafter, employee-shareholders whose compensation is at issue are referred to as the CEO (Chief Executive Officer) or officers.

9 Treas. Reg. § 1.162-7 (2011); *see, e.g.*, Mayson Mfg. Co. v. Comm'r, 178 F.2d 115, 119 (6th Cir. 1949); Elliotts, Inc. v. Comm'r, 716 F.2d 1241, 1245–48 (9th Cir. 1983).

10 *Exacto Spring*, 196 F.3d at 835–37.

11 *Id.* at 839.

using multiple objective factors. Finally, we offer a few of our own thoughts and suggestions.[12]

Whether courts supplant current reasonable compensation jurisprudence with the *Exacto Spring* approach can be dispositive.[13] *Exacto Spring* thus gives rise to a potentially outcome determinative split in approach between the circuits regarding one of the most frequently litigated tax issues. Supreme Court intervention would not be surprising, and additional discussion remains warranted.

I. *EXACTO SPRING* OVERSTATES THE JUDICIAL TREND REGARDING THE INDEPENDENT INVESTOR PERSPECTIVE AND RETURN ON EQUITY[14]

Except for the Seventh Circuit in *Exacto Spring* and *Menard, Inc. v. Commissioner*,[15] courts have used multiple objective factors to determine reasonable compensation.[16] Although the sets of factors vary from circuit to circuit, they are similar.[17]

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12 We are not the first to discuss the reasonable compensation issue recently. *See, e.g.*, Jason L. Behrens, *What Is Reasonable Compensation for Deduction Purposes? Two Tests Exist But Neither Paints a Clear Picture, as Evidenced in* Devine Bros. v. Commissioner, 57 TAX LAW. 793 (2004); Heather L. Hathaway, *Determining the Deductibility of Executive Compensation:* Exacto Spring Corp. v. Commissioner, 53 TAX LAW. 919 (2000); *see generally* Duthler, *supra* note 2.

13 Courts have both held compensation to be unreasonable despite return on equity sufficient to satisfy an independent investor and held compensation to be reasonable despite return on equity insufficient to satisfy an independent investor. In *Owensby & Kritikos, Inc. v. Commissioner*, the Tax Court held the compensation therein unreasonable despite acknowledging the taxpayer's return on equity compared favorably to that of comparable companies. Owensby & Kritikos, Inc. v. Comm'r, 50 T.C.M. (CCH) 29, 43–48 (1985). The Fifth Circuit affirmed. Owensby & Kritikos, Inc. v. Comm'r, 819 F.2d 1315, 1334 (5th Cir. 1987). It viewed the taxpayer's return on equity of 212.5% and 47.6% for the two years at issue as "impressive" and "far in excess of the return on equity of most comparable, publicly traded corporations" but rejected the taxpayer's contention that this raised a "substantial presumption" the compensation was reasonable. *Id.* at 1327. In *John L. Ginger Masonry, Inc. v. Commissioner*, the Tax Court held the compensation therein reasonable despite the taxpayer's return on equity for the three years at issue of 1%, negative 13%, and 2%, for an average of negative 3.33% (return on equity for the previous five years averaged 45.2%). John L. Ginger Masonry, Inc. v. Comm'r, 73 T.C.M. (CCH) 2921, 2928–29 (1997). The Tax Court justified its holding on two points. First, the taxpayer's masonry contracting business was affected by a "precipitous drop in the residential housing market" that began in the first year at issue. *Id.* at 2928. Second, the officer "had foregone compensation in prior years in an attempt to enlarge [the taxpayer's] capital base in order to satisfy the demands of the large developers." *Id.*

14 We are not alone in many of our opinions expressed in this section. *See, e.g.*, Hathaway, *supra* note 12, at 924–26.

15 Menard, Inc. v. Comm'r, 560 F.3d 620 (7th Cir. 2009).

16 Mayson Mfg. Co. v. Comm'r, 178 F.2d 115, 119 (6th Cir. 1949). Unless otherwise indicated, references herein to *Mayson Manufacturing* are to the Sixth Circuit opinion.

17 Duthler, *supra* note 2, at 1953.

Courts view no single factor as dispositive and weigh the totality of facts and circumstances.[18]

The two most commonly used sets of factors are those set forth in *Mayson Manufacturing Company v. Commissioner*[19] and *Elliotts, Inc. v. Commissioner*.[20] *Mayson Manufacturing* set forth nine factors: (1) officer qualifications; (2) nature, extent, and scope of the officer's work; (3) business size and complexity; (4) comparison of officer salary to business gross income and net income; (5) prevailing general economic conditions; (6) comparison of officer salary with distributions to stockholders; (7) prevailing rates of compensation for comparable positions and comparable businesses; (8) taxpayer salary policy for all employees; and (9) prior compensation paid to the officer.[21] *Elliotts* set forth five factors: (1) officer role in the company, including position held, hours worked, and duties performed, as well as general importance of the officer to company success; (2) comparison of the officer's salary with those paid by similar companies for similar services; (3) character and condition of the company, including its sales, net income, and capital value, as well as business complexity and general economic conditions; (4) potential conflicts of interest, including the independent investor standard; and (5) internal inconsistency in a company's treatment of payments to employees.[22]

In the 1949 *Mayson Manufacturing* case, one factor is comparison of officer salary with distributions to stockholders.[23] In the 1950s and 1960s, when addressing both the "intent" and "amount" tests, courts often looked to whether dividends had been paid.[24] In 1970, the Court of Claims decided *Charles McCandless Tile Service v. United States*, which gave rise to the "automatic dividend" rule.[25] Despite being generally profitable, the *McCandless* taxpayer had paid no dividends since its inception. The Court of Claims found that, even though the compensation was reasonable in amount (satisfied the "amount" test), the failure to pay dividends indicated "any return on equity

18 *Mayson*, 178 F.2d at 119.

19 *Id.*

20 Elliotts, Inc. v. Comm'r, 716 F.2d 1241, 1245–46 (9th Cir. 1983). Unless otherwise indicated, references herein to *Elliotts* are to the Ninth Circuit opinion. *See also* McCoskey, *supra* note 2, at 229–30.

21 *Mayson*, 178 F.2d at 119.

22 *Elliotts*, 716 F.2d at 1245–47.

23 *Mayson*, 178 F.2d at 119.

24 *E.g.*, Pac. Grains, Inc. v. Comm'r, 399 F.2d 603, 606–07 (9th Cir. 1968).

25 Charles McCandless Tile Serv. v. United States, 422 F.2d 1336, 1339–40 (Ct. Cl. 1970); Michael Q. Eagan, *Reasonable Compensation and the Close Corporation:* McCandless*, the Automatic Dividend Rule, and the Dual Level Test*, 26 STAN. L. REV. 441, 445 (1974).

capital is so conspicuous by its absence as to indicate . . . the purported compensation payments necessarily contained a distribution of corporate earnings" (failed the "intent" test) and, therefore, disallowed the compensation deduction in the amount needed to leave a fifteen percent return on equity.[26] In essence, *McCandless* imposed a "substance over form" analysis into the "intent" test.

With respect to the "amount" test, in the 1970s courts began to speak occasionally in terms of the independent investor and return on equity, not just in terms of dividend payments. For example, in 1974 in *Edwin's, Inc. v. United States*, the Seventh Circuit noted the taxpayer's profit exceeded twenty percent of invested capital.[27] The previous year, in *Charles Schneider & Company v. Commissioner*[28] and in *Carole Accessories, Inc. v. Commissioner*,[29] and in 1980 in *Cromer v. Commissioner*,[30] the Tax Court viewed failure to pay dividends as evidencing unreasonable compensation because independent investors would demand a return on their capital. In 1981, in *Foos v. Commissioner*, the Tax Court viewed return on equity as one of twenty-one factors to be weighed in the "amount" test.[31]

In *Exacto Spring*, to justify abandoning multiple objective factors, the Seventh Circuit characterized three previous circuit opinions as "moving toward a much simpler and more purposive test, the 'independent investor' test."[32] The first opinion, *Elliott*s, was issued by the Ninth Circuit in 1983.[33] The second and third opinions, *RAPCO, Inc. v. Commissioner*[34] and *Dexsil Corporation v. Commissioner*,[35] were issued by the Second Circuit in the 1990s. All three opinions merely called for an examination as to whether return on equity would satisfy an independent investor as *one* of the "amount" test multiple objective factors.

In *Elliotts,* the Ninth Circuit rejected the *McCandless* "automatic dividend" rule.[36] The Court noted that dividend payment is not legally mandated and it may be in the best

26 *McCandless*, 422 F.2d at 1339–40.

27 Edwin's, Inc. v. United States, 501 F.2d 675, 677 (7th Cir. 1974).

28 Charles Schneider & Co., Inc. v. Comm'r, 32 T.C.M. (CCH) 555, 568 (1973).

29 Carole Accessories, Inc. v. Comm'r, 32 T.C.M. (CCH) 1285, 1290 (1973).

30 Cromer v. Comm'r, 40 T.C.M. (CCH) 701, 705 (1980).

31 Foos v. Comm'r, 41 T.C.M. (CCH) 863, 878–79 (1981).

32 Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 838 (7th Cir. 1999).

33 Elliotts, Inc. v. Comm'r, 716 F.2d 1241 (9th Cir. 1983).

34 RAPCO, Inc. v. Comm'r, 85 F.3d 950 (2d Cir. 1996). Unless otherwise indicated, references herein to *RAPCO* are to the Second Circuit opinion.

35 Dexsil Corp. v. Comm'r, 147 F.3d 96 (2d Cir. 1998). Unless otherwise indicated, references herein to *Dexsil* are to the Second Circuit opinion.

36 *Elliotts*, 716 F.2d at 1244.

interests of the company and shareholders for funds to be retained and reinvested in the company.[37] The Ninth Circuit looked at each of the *Elliotts* factors.[38] With respect to the "independent investor standard," it stated as follows:

> [I]t is appropriate to evaluate the compensation payments from the perspective of a hypothetical independent shareholder. If the bulk of the corporation's earnings are being paid out in the form of compensation, so that the corporate profits, after payment of the compensation, do not represent a reasonable return on the shareholder's equity in the corporation, then an independent shareholder would probably not approve of the compensation arrangement. If, however, that is not the case, and the company's earnings on equity 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.[39]

The Ninth Circuit viewed the taxpayer's average return on equity of twenty percent for the two years at issue as likely sufficient to satisfy an independent investor and held that the Tax Court erred by limiting its analysis to the taxpayer's failure to pay dividends and remanded the case.[40]

Since *Elliotts*, courts generally look to the viewpoint of the independent investor in reasonable compensation cases, but do so only with respect to the "amount" test.[41] As long as the formalities of calling payments compensation are observed, courts hold the "intent" test to be met.[42] After migration to the "amount" test, the viewpoint of the independent investor became just one of several factors and lost its potential trump power exercised in *McCandless* via the "intent" test.[43]

In *RAPCO*, even though the taxpayer's return on equity for the years at issue compared favorably to that of the Standard & Poor's 500, the Tax Court sustained most of the compensation disallowance.[44] The Second Circuit looked to the *Elliotts* factors

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37 *Id.*

38 *Id.* at 1245–48.

39 *Id.* at 1247.

40 *Id.* at 1247–48. The Tax Court did not change its holding on remand. However, it carefully crafted its explanations for not doing so from the viewpoint of a "hypothetical independent investor." For example, it reconsidered the taxpayer's return on equity, but found it too low in comparison to comparable companies. Elliotts, Inc. v. Comm'r, 48 T.C.M. (CCH) 1245, 1249–50 (1984), *aff'd*, 782 F.2d 1051 (9th Cir. 1986).

41 *See* RAPCO, Inc. v. Comm'r, 85 F.3d 950, 954–55 (2d Cir. 1996).

42 McCoskey, *supra* note 2, at 228; *see, e.g.*, Dexsil Corp. v. Comm'r, 147 F.3d 96, 100–01 (2d Cir. 1998).

43 *Id.*

44 RAPCO, Inc. v. Comm'r, 69 T.C.M. (CCH) 2238, 2241 (1995), *aff'd*, 85 F.3d at 955–56.

and affirmed.[45] In response to the taxpayer's argument that the Tax Court gave too little consideration to the effect its "impressive" return on equity would have on a "disinterested shareholder," the Second Circuit noted that the Tax Court "explicitly conceded that [the taxpayer] had a substantial return on equity" but "correctly acknowledged . . . return on equity is only one factor"; and "the [Tax Court] appropriately discounted this factor, in the absence of evidence comparing [the taxpayer's] return on equity to that of *similar* companies."[46] In *Dexsil*, although the Second Circuit held the Tax Court erroneously failed to consider the compensation at issue "from the perspective of an independent investor,"[47] it clearly viewed all of the *Elliotts* factors as relevant.[48]

After *Elliotts*, but prior to *Exacto Spring*, if reliable evidence regarding return on equity was available, the Tax Court generally viewed such evidence as indicative of reasonable compensation,[49] while in a few cases, it viewed such evidence as indicating compensation was unreasonable.[50] However, no court other than the Seventh Circuit has interpreted *Elliotts*, *RAPCO*,

45 *RAPCO*, 85 F.3d at 955–56.

46 *Id.*

47 *Dexsil*, 147 F.3d at 101, 103. On remand, the Tax Court did not agree that an independent investor would be satisfied with a return on equity equal to that of major stock exchange companies, stating "[i]f that were the law, any amount of compensation would be regarded as reasonable as long as a minimal average return . . . was reflected on the company's balance sheets." Dexsil Corp. v. Comm'r, 77 T.C.M. (CCH) 1973, 1975 (1999).

48 *Dexsil*, 147 F.3d at 100.

49 *See, e.g.*, Webster Tool & Die, Inc. v. Comm'r, 51 T.C.M. (CCH) 86, 91 (1985); M. & E. Shindler, Inc. v. Comm'r, 63 T.C.M (CCH) 3039, 3039–40 (1992); Auto. Inv. Dev., Inc. v. Comm'r, 66 T.C.M. (CCH) 57, 67 (1993); Mortex Mfg. Co., Inc. v. Comm'r, 67 T.C.M. (CCH) 2412, 2419 (1994); L & B Pipe & Supply Co. v. Comm'r, 67 T.C.M. (CCH) 2798, 2805–06 (1994); Universal Mfg. Co., Inc. v. Comm'r, 68 T.C.M. (CCH) 305, 314 (1994); Sunbelt Clothing Co., Inc. v. Comm'r, 74 T.C.M. (CCH) 195, 197 (1997); Tricon Metals & Serv., Inc. v. Comm'r, 74 T.C.M. (CCH) 287, 292 (1997); Choate Constr. Co. v. Comm'r, 74 T.C.M. (CCH) 1092, 1098 (1997). Over this period, federal district courts looked to and used the "independent investor" test in a manner similar to the Tax Court. *See, e.g.*, Trucks, Inc., v. United States, 588 F. Supp. 638, 647 (D. Neb. 1984), *aff'd*, 763 F.2d 339 (8th Cir. 1985); Shaffstall Corp. v. United States, 639 F. Supp. 1041, 1047 (S.D. Ind. 1986).

50 *See, e.g.*, Donald Palmer Co. v. Comm'r, 69 T.C.M. (CCH) 1869, 1872–73 (1995); H & A Int'l Jewelry, Ltd. v. Comm'r, 74 T.C.M. (CCH) 915, 922 (1997); LabelGraphics, Inc. v. Comm'r, 76 T.C.M. (CCH) 518, 527–28 (1998); Escrow Connection, Inc. v. Comm'r, 73 T.C.M. (CCH) 1705, 1711 (1997). In *Alpha Medical, Inc. v. Commissioner*, 74 T.C.M. (CCH) 893, 901 (1997), the Tax Court held part of the claimed compensation unreasonable despite finding equity grew considerably during the CEO's tenure and the year's 98.65% return on equity was impressive. The Sixth Circuit reversed and held the compensation reasonable, opining that the Tax Court placed insufficient emphasis on the favorable growth in equity and return on equity. Alpha Med., Inc. v. Comm'r, 172 F.3d 942, 949, 952 (6th Cir. 1999).

or *Dexsil* as calling for abandoning the use of multiple objective factors.[51]

II. *EXACTO SPRING* AND OTHER COURTS' RELUCTANCE TO FOLLOW ITS APPROACH

A. *Exacto Spring*

In *Exacto Spring*, the taxpayer, a manufacturer of precision springs, paid its chief executive (also cofounder and principal owner) $1.3 million in 1993 and $1 million in 1994.[52] The Service contended that the proper compensation for these years was $381,000 and $400,000, respectively.[53] Using a seven-factor objective test, the Tax Court held the proper compensation for the years at issue was $900,000 and $700,000, respectively.[54] The Seventh Circuit reversed and held that all of the compensation paid to the chief executive was reasonable.[55]

The Seventh Circuit opined that using multiple objective factors "leaves much to be desired—being like many other multi-factor tests, 'redundant, incomplete, and unclear.'"[56] The Seventh Circuit held this based on the following reasons: (1) "it is nondirective . . . [with] no indication . . . of how the factors are to be weighed . . . and many of the factors . . . are vague"; (2) "the factors do not bear a clear relation either to each other or to the primary purpose of section 162(a)(1)"; (3) it "invites the Tax Court to set itself up as a superpersonnel department for closely-held corporations, a role unsuitable for courts"; (4) "it invites the making of arbitrary decisions based on uncanalized discretion or unprincipled rules of thumb"; and (5) "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."[57] The Seventh Circuit used *Exacto Spring* to exemplify its views regarding the use of multiple objective factors,[58] abandoning it in favor of an "indirect market test," which is stated as follows:

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51 Moran, *supra* note 4, at A-18.

52 Heitz v. Comm'r, 75 T.C.M. (CCH) 2522, 2524 (1998), *rev'd*, 196 F.3d 833 (7th Cir. 1999). The trial court action involved two cases, which were consolidated, the other being *Exacto Spring Corp. v. Commissioner*. *Id.* at 2522.

53 *Id.* at 2524.

54 *Id.* at 2528.

55 Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 839 (7th Cir. 1999).

56 *Id.* at 835 (internal citation omitted).

57 *Id.*

58 *Id.* at 836–38.

> 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 [because] 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. The Service's expert believed that investors in a firm like Exacto would expect a 13 percent return on their investment. Presumably they would be delighted with more. They would be *overjoyed* to receive a return more than 50 percent greater than they expected—and 20 percent, the return that the Tax Court found that investors in Exacto had obtained, is more than 50 percent greater than the benchmark return of 13 percent.
>
> 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. We say "presumptively" because we can imagine cases in which the return, though very high, is not due to the CEO's exertions. Suppose Exacto had been an unprofitable company that suddenly learned that its factory was sitting on an oil field, and when oil revenues started to pour in its owner raised his salary from $50,000 a year to $1.3 million. The presumption of reasonableness would be rebutted. There is no suggestion of anything of that sort here and likewise no suggestion that Mr. Heitz was merely the titular chief executive and the company was actually run by someone else, which would be another basis for rebuttal.[59]

B. Other Circuits and the Tax Court Decline to Follow *Exacto Spring*

Between *Exacto Spring* and *Menard,* the Tax Court decided several reasonable compensation cases. It did not adopt the *Exacto Spring* approach in any of these cases, despite considerable taxpayer prodding to do so.[60] During the period, several circuits also declined to adopt the *Exacto Spring* approach despite considerable taxpayer prodding to do so.[61]

59 *Id.* at 838–39.

60 *See* McCoskey, *supra* note 2, at 237 (explaining how the Tax Court in *Menard* continued to apply the factors).

61 *See id.* at 230–38 (summarizing the current state of reasonable compensation jurisprudence).

In 2000, in *Normandie Metal Fabricators, Inc. v. Commissioner*, the Tax Court distinguished the case from *Exacto Spring* and looked to the *RAPCO, Inc.* factors from the perspective of an independent investor;[62] the Second Circuit affirmed.[63] In 2001, in *Eberl's Claim Service, Inc. v. Commissioner*, the Tenth Circuit declined to abandon its "traditional multi-factor test of reasonableness outlined in *Pepsi-Cola Bottling*"[64] under which "the situation must be considered as a whole, with no one factor being decisive."[65] In 2003, the Tax Court used the *Owensby & Kritikos*[66] factors to decide *Brewer Quality Homes, Inc. v. Commissioner*; the Fifth Circuit affirmed.[67] In 2003, in *E.J. Harrison & Sons, Inc. v. Commissioner*, the Tax Court rejected the taxpayer's argument grounded in *Exacto Spring* that its favorable return on equity rendered compensation "presumptively reasonable"; the Ninth Circuit affirmed in relevant part.[68] In 2003, in *Haffner's Service Stations, Inc. v. Commissioner*, the First Circuit stated that the section 162 regulations require reasonableness to be based on "all circumstances" and rejected the taxpayer's urging to adopt the *Exacto Spring* approach.[69] In 2004, in *Metro Leasing and Development Corp. v. Commissioner*, the Ninth Circuit again declined to adopt the *Exacto Spring* approach and stated that courts should examine the "nature and quality of the services" an officer provides "as well as the effect of those services on the return the investor is seeing on his investment."[70]

C. *Menard*

Menards is a retailer of hardware, building supplies, paint, garden equipment, and similar items.[71] During the year at issue, the company had approximately 160 stores in nine Midwestern

62 Normandie Metal Fabricators v. Comm'r, 79 T.C.M. (CCH) 1738, 1743 (2000).

63 Normandie Metal Fabricators v. Comm'r, 10 F. App'x 26 (2d Cir. 2001).

64 Pepsi-Cola Bottling Co. of Salina, Inc. v. Comm'r, 528 F.2d 176, 179 (10th Cir. 1975).

65 Eberl's Claim Serv. v. Comm'r, 249 F.3d 994, 999 (10th Cir. 2001) (quoting *Pepsi-Cola*, 528 F.2d at 179).

66 Owensby & Kritikos v. Comm'r, 819 F.2d 1315, 1323 (5th Cir. 1987).

67 Brewer Quality Homes v. Comm'r, 86 T.C.M. (CCH) 29, 35 (2004), *aff'd*, 122 F. App'x 88 (5th Cir. 2004).

68 E.J. Harrison and Sons, Inc. v. Comm'r, 86 T.C.M. (CCH) 240, 252–53 (2003), *aff'd*, 138 F. App'x 994 (9th Cir. 2005). The officer whose compensation was at issue was the mother of three other corporate officers. The Tax Court found the taxpayer's profitability to be attributable to the sons' efforts and viewed this as strong evidence of intent to distribute profits to the mother in the guise of compensation. *Id.* at 253.

69 *See* Haffner's Serv. Stations v. Comm'r, 326 F.3d 1, 3–4 (1st Cir. 2003).

70 Metro Leasing and Dev. Corp. v. Comm'r, 376 F.3d 1015, 1019 (9th Cir. 2004) (quoting Elliotts v. Comm'r, 716 F.2d 1241, 1245 (9th Cir. 1983)).

71 Menard, Inc. v. Comm'r, 88 T.C.M. (CCH) 229, 231 (2004), *aff'd*, 560 F.3d 620 (7th Cir. 2009).

states and was one of the nation's top retail home improvement chains (third only to Home Depot and Lowe's).[72] That year, it paid its CEO $20,642,485.[73] Because the case was appealable to the Seventh Circuit, the Tax Court was obligated to follow *Exacto Spring* or explain why it did not do so.[74]

In its post-trial Tax Court brief, the Service conceded that the taxpayer's return on equity for the year at issue would have satisfied an independent investor, and thus, the compensation passed the *Exacto Spring* "amount" test.[75] The Tax Court refused to accept the concession on its terms, instead treating it as a concession that a presumption of reasonableness arose; a presumption rebuttable by evidence demonstrating the compensation "substantially exceeded . . . [that] paid by comparable publicly traded corporations to their CEO."[76] The Tax Court viewed the ability of such evidence to rebut the presumption of reasonableness as flowing from Regulation 1.162-7(b)(3), which requires courts to consider "evidence of how the marketplace values the services of comparably situated executives"[77] including "evidence of compensation paid to CEOs in comparable companies."[78]

Both parties' experts accepted the Black-Scholes model as appropriate and agreed five publicly traded companies were comparable to the taxpayer: Home Depot, Kohl's, Lowe's, Staples, and Target.[79] Because the taxpayer CEO's compensation was multiple times higher than that of the comparable CEOs (two times the Target CEO, three times the Staples and Lowe's CEO, four times the Kohl's CEO, and seven times the Home Depot CEO), the Tax Court held that any presumption that the taxpayer CEO's compensation was reasonable was rebutted.[80] It then looked to the record as a whole to determine the amount of reasonable compensation.[81]

72 *Id.*

73 *Id.* at 230.

74 *See* Lardas v. Comm'r, 99 T.C. 490, 494–95 (1992) (explaining that under the *Golsen* doctrine the Tax Court will follow "squarely on point" precedents of the Circuit to which appeal of its decision would lie).

75 *Menard*, 88 T.C.M. (CCH) at 238. The Service relied solely on its "intent" test argument characterizing the disallowed compensation as a disguised dividend.

76 *Id.* at 238.

77 *Id.* at 238 n.34.

78 *Id.* at 239. The Tax Court noted the Seventh Circuit did not discuss or declare the regulation invalid in *Exacto Spring*. *Id.* at 238.

79 *Id.* at 241.

80 *Id.* at 243.

81 *Id.*

The Tax Court viewed Home Depot and Lowe's as most "directly comparable" to the taxpayer.[82] It started with Home Depot CEO's compensation of $2,841,307. It multiplied this amount by 18.8% divided by 16.1%, because the taxpayer's return on equity (18.8%) was higher than Home Depot's (16.1%). This yielded $3,317,799. The Tax Court then multiplied that amount by 213%, because Lowe's CEO's compensation was 2.13 times higher than Home Depot's CEO's. This yielded $7,066,912, which the Tax Court held to be the amount of reasonable compensation.[83]

The Seventh Circuit reversed and held reasonable the entire amount the taxpayer characterized as compensation, $20,642,485.[84] Specifically, the Seventh Circuit held the Tax Court committed clear error by holding that the reasonableness presumption was rebutted by evidence of comparable companies' CEO compensation.[85]

In the one Tax Court reasonable compensation case appealable to the Seventh Circuit since *Menard*, the Tax Court acknowledged that a sufficiently high rate of return could give rise to a rebuttable presumption of reasonableness (although the rate of return therein did not suffice), while in the only other reasonable compensation case decided subsequent to *Menard* the Tax Court did not follow *Exacto Spring* and *Menard*.[86] No circuit has addressed the reasonable compensation issue since *Menard*.

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82 *Id.*

83 *Id.* at 244. The Tax Court also held that the CEO's compensation failed the "intent" test and constituted a disguised dividend to the extent it exceeded $7,066,912. It noted the taxpayer had never paid a dividend despite tremendous growth; the compensation was paid in a single five percent bonus lump sum rather than as services were performed; the compensation was profit-based (five percent of net income); the CEO agreed to reimburse the taxpayer if any portion of the compensation was disallowed; and the board of directors (all of whom were employees of the taxpayer or members of the CEO's family or both) made no effort to ascertain the market value of compensation paid to CEOs of comparable companies or to periodically evaluate the taxpayer's compensation formula. *Id.* at 244–45.

84 Menard v. Comm'r, 560 F.3d 620, 628 (7th Cir. 2009).

85 *Id.* at 625–28. In the words of the Seventh Circuit, "[t]here is no suggestion that any of the shareholders were disappointed that the company obtained a rate of return of 'only' 18.8 percent or that the company's success in that year or any year has been due to windfall factors, such as the discovery of oil under the company's headquarters." *Id.* at 624. The Seventh Circuit also overruled the Tax Court's disguised dividend holding. *Id.* at 625.

86 *See* Mulcahy, Pauritsch, Salvador & Co., LTD. v. Comm'r, T.C. Mem. 2011-74 (Mar. 31, 2011); Multi-Pak Corp. v. Comm'r, 99 T.C.M. (CCH) 1567, 1570 (2010) (applying the *Elliotts* factors).

III. *EXACTO SPRING* IS INCONSONANT WITH SECTION 162, ITS REGULATIONS AND ITS OTHER CASE LAW

A. *Exacto Spring* Is Inconsonant with Section 162

Scholars have identified four methods of statutory interpretation used by courts: intentionalism, purposivism, textualism, and the dynamic method.[87] According to intentionalism, even if statutory language appears clear, courts should examine legislative history to discern what the enacting legislature intended the statute to mean.[88] That is, courts should essentially act as agents of the enacting legislature. According to purposivism, courts should discern a statute's original purpose by examining legislative history in the context of enactment circumstances.[89] According to textualism, courts should not look to a statute's legislative history but rather to its text in the context of surrounding law.[90] According to the dynamic method, courts should look not only to a statute's text and historical background but also to society's contemporary needs and goals.[91]

In 1934 in *Gregory v. Helvering*, the Second Circuit refused to give tax recognition to a transaction that literally complied with the Code but in its view was not what the statute intended; the Supreme Court affirmed.[92] Since then, courts construing the Code most often speak in terms of intentionalism and purposivism.[93] However, there are a few cases which best fit into the dynamic method mold,[94] and recently some judges, including Supreme Court Justice Antonin Scalia, have argued for and applied textualism.[95]

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87 Noel B. Cunningham & James R. Repetti, *Textualism and Tax Shelters,* 24 VA. TAX REV. 1, 7 (2004); *see generally* Michael Livingston, *Practical Reason, "Purposivism," and the Interpretation of Tax Statutes*, 51 TAX L. REV. 677 (1996); Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose,* 2 FLA. TAX REV. 492 (1995) (discussing how purpose aids in interpreting the Tax Code).

88 Cunningham, *supra* note 87, at 7–8.

89 *Id.* at 8.

90 *Id.* at 8–9.

91 *Id.* at 9–10. *See also* Nicholas S. Zeppos, *Judicial Candor and Statutory Interpretation*, 78 GEO. L.J. 353, 357–58 (1989) ("The new theories of statutory interpretation urge courts to consider, among other factors, a reading of the statute that meets the needs of present day society and best fits society's current moral, social, and legal fabric.").

92 Gregory v. Helvering, 69 F.2d 809, 810–11 (2d Cir. 1934), *aff'd*, 293 U.S. 465, 470 (1935).

93 Cunningham, *supra* note 87, at 12.

94 *C.f.* Livingston, *supra* note 87, at 699 (discussing *Bob Jones University v. United States*, 461 U.S. 574 (1983)).

95 *Id.* at 682.

No matter which method of statutory interpretation courts employ, the starting point is the statute's text.[96] Section 162 provides: "[T]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . a reasonable allowance for salaries or other compensation for personal services actually rendered."[97]

i. Intentionalism and Purposivism

Intentionalism and purposivism look to legislative history and historical background. The Revenue Acts of 1913 and 1916 contained only the general "ordinary and necessary" provision of section 162's predecessor.[98] However, underlying regulations warned of the need to analyze carefully purported compensation payments to officers to ensure such payments were not out of proportion to business volume or excessive when compared to similarly situated employees in other companies; the regulations prescribed "the amount so paid in excess of reasonable compensation for the services will not be deductible from gross income, but will be treated as a distribution of profits."[99]

The Revenue Act of 1918 added the "reasonable allowance for salaries or other compensation" provision.[100] Its legislative history is unclear.[101] According to some commentators, the provision "permit[ted] closely held enterprises to deduct an allowance for services rendered by officers and proprietors in computing the World War I excess profits tax even if no salary was actually paid."[102] In any event, after the excess profits tax expired, the provision came to be interpreted as a disallowance of unreasonable amounts if paid, rather than as an allowance for reasonable amounts that were not paid.[103] By 1930, the Supreme Court implicitly acknowledged such a view in *Lucas v. Ox Fibre Brush Co.*,[104] and since then the "reasonable allowance" provision

96 Cunningham, *supra* note 87, at 10.

97 I.R.C. § 162 (1996).

98 Moran, *supra* note 4, at A-1.

99 *Id.* at A-2. *See also* Barbara F. Sikon, *The Recharacterization of Unreasonable Compensation: An Equitable Mandate,* 51 CLEV. ST. L. REV. 301, 306 (2004).

100 Moran, *supra* note 4, at A-1.

101 *Id.* at A-1. *See also* Sikon, *supra* note 99, at 306.

102 BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 22.2.1 at 22-18 (3d ed. 1999). *See also* Moran, *supra* note 4, at A-1; Sikon, *supra* note 99, at 306.

103 Moran, *supra* note 4, at A-2; BITTKER & LOKKEN, *supra* note 102, at ¶ 22.2.1, 22-18.

104 Lucas v. Ox Fibre Brush Co., 281 U.S. 115, 119 (1930).

has functioned as a limitation rather than an enlargement of compensation deductibility.[105]

While little in the way of intent or purpose can be gleaned from the unusual history of the "reasonable allowance" provision, eighty years of Congressional silence since *Lucas* evidences its assent to the facts and circumstances analysis of Regulation 1.162-7 and multiple objective factors case law. When Congress re-enacts a statute with administrative or judicial interpretative guidance in place, Congress is deemed to give assent to such guidance.[106] The "reasonable allowance" provision with underlying regulations and multiple objective factors case law was in place during the 1954 and 1986 Code re-codifications,[107] and if Congress had been unhappy with these interpretations, presumably it would not have implicitly blessed them by re-enacting the provision verbatim.[108]

In sum, while legislative history and historical background are murky, Congressional re-enactment of section 162 while Regulation 1.162-7 and multiple objective factors case law were in place evidence Congressional approval of these interpretations.

ii. Textualism

Textualism looks to a statute's text and surrounding law.[109] With respect to text, the amorphous phrase "reasonable allowance" evidences Congressional intent to sentence taxpayers, the Service, and courts to messy facts and circumstances analysis in reasonable compensation controversies. Congress imposes many such sentences in the Code: for example, determining whether an activity is engaged in for profit (section 183); determining whether related party transactions are at arm's length (section 482); and computing reasonable capital needs of a business for purposes of the accumulated earnings tax (section 531).[110] When Congress wants to have a characterization

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105 Moran, *supra* note 4, at A-1; BITTKER & LOKKEN, *supra* note 102, at ¶ 22.2.1, 22-18.

106 Lorillard, A Div. of Loew's Theatres, Inc. v. Pons, 434 U.S. 575, 580–82 (1978).

107 I.R.C. preface § 1 (2006); BITTKER & LOKKEN, *supra* note 102, at ¶ 22.2.1.

108 Analogously, a recent law review article observes that regarding I.R.C. § 482 "[b]y enacting and repeatedly reenacting section 482 and its predecessors, Congress has affirmed its initial decision to confront the problem of abusive transfer pricing, not with precise statutory formulae or hosts of special accounting rules, but with a generic standard heavily reliant upon the Commissioner's exercise of discretion." Francis M. Allegra, *Section 482: Mapping the Contours of the Abuse of Discretion Standard of Judicial Review*, 13 VA. TAX REV. 423, 444 (1994).

109 William N. Eskridge, Jr., *The New Textualism*, 37 UCLA L. REV. 621, 621 (1990).

110 I.R.C. §§ 183, 482, 531, and other such sentences abound in areas of the law other than tax law. As noted by Moran, *supra* note 4, at A-3, "[t]he concept [of reasonableness

question settled by a bright line test, it knows how to do so: for example, the material participation test under the passive loss rules (section 469); the definition of alimony (section 71); and the definition of passive gains under subchapter S (section 1375).[111] But in section 162 Congress decided against a bright line for reasonable compensation.

With respect to context, courts have held a "reasonable in amount" limitation inherent in the section 162 "ordinary and necessary" provision,[112] and section 482 grants the Service discretion to reallocate income and deductions among related parties to reflect an arm's length standard.[113] These provisions reflect the recurrent tax law theme of ensuring related party transactions are treated for tax purposes as if they had occurred between unrelated parties.[114] Determining the amount a taxpayer would have paid an unrelated party for the same goods and services entails a facts and circumstances test very akin to the reasonable compensation determination approach of Regulation 1.162-7 and multiple objective factors case law.

In sum, the amorphous language of section 162 coupled with the contextual tax law theme regarding related party transactions evidences that Regulation 1.162-7 and multiple objective factors case law are proper interpretations of section 162.

iii. Dynamic Method

The dynamic interpretative approach looks to society's contemporary needs and goals. According to the Seventh Circuit, a simpler, bright line test is needed to determine reasonable compensation.[115] As discussed below, the *Exacto Spring* approach increases rather than decreases the complexity of reasonable compensation controversies.

Even if the *Exacto Spring* approach did reduce complexity, such simplicity might come at too high a price. To some extent, the "rules" approach of *Exacto Spring* versus the "principles" approach of multiple objective factors reflects the "rules versus principles" debate now ongoing with respect to both tax law and

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for compensation] defies simple interpretation by tax experts in the same manner that the hypothetical reasonable man escapes precise definition by negligence lawyers and the concept of reasonable doubt remains an elusive factor in criminal law."

111 I.R.C. § 469(c)(4) (2006); I.R.C. § 71(b)(1) (2006); I.R.C. § 1375(b) (2006).

112 Noyce v. Comm'r, 97 T.C. 670, 687–88 (1991); *see also* Comm'r v. Lincoln Electric Co., 176 F.2d 815, 817–18 (6th Cir. 1949).

113 BITTKER & LOKKEN, *supra* note 102, at ¶ 4.3.3; Allegra, *supra* note 108, at 429–31.

114 ROBERT COLE, PRACTICAL GUIDE TO U.S. TRANSFER PRICING § 24.01 (Matthew Bender ed., 3d ed. 2011).

115 Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 838 (7th Cir. 1999).

financial accounting.[116] It is perhaps overly simple, but not inaccurate, to summarize this debate as revealing there are advantages and disadvantages for both rules and principles for most applications. Policymakers must pick their poison.[117]

To recap, intentionalism, purposivism, textualism, and dynamic statutory interpretation all indicate courts should not abandon using multiple objective factors in favor of the *Exacto Spring* approach in reasonable compensation cases.

Furthermore, in the absence of statutory language to the contrary or a compelling public policy reason, tax statutes should be construed without presumption.[118] In *Exacto Spring*, the Seventh Circuit attempts to coin a presumption that compensation is reasonable if it leaves sufficient return on equity.[119] As is apparent herein, neither the text of section 162 nor its related policy concerns warrant such a presumption.

B. *Exacto Spring* is Inconsonant with Section 162 Regulations

The relevant section 162 regulations were promulgated pursuant to section 7805(a), which authorizes the Treasury Department to promulgate regulations interpreting the Code.[120] In *Mayo Foundation for Medical Education and Research v. United States*, the Supreme Court recently held that such regulations must be followed if they represent a "reasonable interpretation" of the relevant Code section.[121]

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116 *See* Tracy Stetson, *Rules Versus Principles: Accountants' Cognitive Styles and Professional Penalties*, 67:12 J. PSYCHOLOGICAL TYPE 115, 118 (2007).

117 *See generally* Mark W. Nelson, *Behavioral Evidence on the Effects of Principles—and Rules-Based Standards*, 17 ACCT. HORIZONS 91 (2003); *see, e.g.*, John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 WASH. L. REV. 1, 5 (1993) ("[T]ax law is a system of rules that depends on constant and creative adaptation to meet changing circumstances" and "these themes argue for an approach toward tax rule making that is less concerned with details and more concerned with establishing fair general principles."). When Congress has considered using a mechanical approach for transfer pricing, seasoned members of the tax bar such as Sheldon Cohen (former Service Commissioner) have pointed out that, while the simplicity of such an approach is inviting, "fixed rates or formulas could produce arbitrary and unreasonable results." Sheldon S. Cohen, *How the IRS Intends to Administer the New Regulations Under Section 482*, 28 J. TAX'N 73, 73 (1968).

118 Peter A. Lowy & Juan F. Vasquez, Jr., *Interpreting Tax Statutes: When Are Statutory Presumptions Justified?*, 4 HOUS. BUS. & TAX L.J. 389, 393 (2004).

119 *Exacto Spring*, 196 F.3d at 837–38.

120 28 U.S.C. § 7805(a) (2006).

121 Mayo Found. for Med. Educ. and Research v. United States, 131 S. Ct. 704 (2011). In *Mayo Foundation* the Supreme Court held that generally courts must use the two-step analysis of *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, *Inc.*, 467 U.S. 837, 842–43 (1984), when evaluating the validity of Treasury Regulations issued under I.R.C. § 7805(a). Simply stated, under this analysis: (1) if the intent of Congress is clear, courts must give effect to this intent, but (2) if a statute is silent or ambiguous, relevant regulations must be upheld unless they are arbitrary, capricious or manifestly contrary to the statute.

Again, Regulation 1.162-7(b)(3) prescribes that "[i]n any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances" and that "[i]t is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."[122] The Seventh Circuit does not mention the regulation in *Exacto Spring*. In *Menard*, it dismisses the regulation as "not an operational standard,"[123] but cites no authority to justify ignoring regulations for such a reason. We are aware of no case in which a party (or a court) challenged Regulation 1.162-7 as not representing reasonable statutory interpretation or as inconsonant with Congressional intent. Even if the *Exacto Spring* approach is a "better" or even the "best" approach to determining reasonable compensation, it is legally improper for the Seventh Circuit to substitute such approach for that of Regulation 1.162-7.[124]

One can view *Exacto Spring* as consonant with Regulation 1.162-7 if one believes company owners actually determine officer compensation by looking solely to return on equity.[125] Empirical studies indicate company owners consider much more than return on equity. For example, one survey of 587 firms indicates that only four percent of firms relied exclusively on return on equity.[126] To reduce the myopic behavior that specific metrics may cause, most firms use multiple metrics, including various ratios, income and revenue targets, and non-financial measures such as quality and innovation.[127] Further, many reputable scholars question the behavioral assumptions of Law and Economics theory, upon which *Exacto Spring* is based.[128]

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122 Treas. Reg. § 1.162-7(b)(3) (1960).

123 Menard, Inc. v. Comm'r, 560 F.3d 620, 622 (7th Cir. 2009).

124 *See* David A. Brennen, *Treasury Regulations and Judicial Deference in the Post-*Chevron *Era,* 13 GA. ST. U. L. REV. 387, 395 (1997). Other law review articles agree with our view that *Exacto Spring* and *Menard* are inconsonant with applicable regulations. *See, e.g.*, Hathaway, *supra* note 12, at 927.

125 The Seventh Circuit cited no empirical evidence to this effect. A recent law review article notes, "[i]n the absence of empirical studies, [Posner] frequently engages in common sense speculation about potential consequences of particular decisions." Linda E. Fisher, *Pragmatism Is as Pragmatism Does: Of Posner, Public Policy and Empirical Reality*, 31 N.M. L. REV. 455, 470 (2001).

126 Linda Amuso & David Knopping, *Incentive Compensation Program Design*, *in* THE COMPENSATION HANDBOOK 205, 211 (5th ed. 2008).

127 *Id.* at 209–10.

128 *See, e.g.*, Grant M. Hayden & Stephen E. Ellis, *Law and Economics After Behavioral Economics*, 55 U. KAN. L. REV. 629 (2007); Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998); Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551 (1998); Adam Chodorow, *Economic Analysis in Judicial Decision Making—An Assessment Based on Judge Posner's Tax Decisions*, 25 VA. TAX REV. 67 (2005); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality*

In sum, the Seventh Circuit's lack of deference to Regulation 1.162-7 in favor of Law and Economics theory is not legally proper. Because taxpayers' trust in and deference to Treasury Regulations is grounded in the expectation that courts will follow them, such judicial refusal to follow Treasury regulations may have negative consequences.[129]

C. Exacto Spring Is Inconsonant with Other Section 162 Case Law

Judge Posner, author of *Exacto Spring* and *Menard*, has criticized use of multiple factors and reversed trial courts' use of such analysis in a number of legal contexts;[130] he has imposed standards derived from his economic theory in lieu of established legal standards in several cases across varied areas of the law.[131] Discussion of the propriety of this practice by Judge Posner, in general, is beyond the scope of this article. However, in our opinion, even if such practice might be appropriate in some areas of the law, it is not appropriate with respect to reasonable compensation jurisprudence.

Assumption from Law and Economics, 88 CALIF. L. REV. 1051 (2000); Fisher, *supra* note 125. Exploration of Law and Economics theory is beyond the scope of this article. In short, it posits humans as rational creatures seeking to maximize their satisfaction by making choices and weighing costs and benefits of alternative courses of action. For an introductory discussion, we recommend Chapter 5 "Law and Economics" in JEFFRIE G. MURPHY & JULES L. COLEMAN, PHILOSOPHY OF LAW: AN INTRODUCTION TO JURISPRUDENCE 181 (Revised ed. 1989). *See also* Daniel T. Ostas, *Postmodern Economic Analysis of Law: Extending the Pragmatic Visions of Richard A. Posner*, 36 AM. BUS. L.J. 193 (1998); Chodorow, *supra*. Fisher, *supra* note 125, has many positive things to say about Judge Posner's jurisprudence but argues that "at times, Judge Posner acts like a chancellor in equity, independently adjudicating facts and sometimes ignoring settled law, rather than as an appellate judge reviewing lower court decisions." *Id.* at 458.

129 Brennen, *supra* note 124, at 388–89, notes as follows:

> Without question, the federal tax code is the most technical and complex of all federal statutory schemes. Given this level of complexity, the Treasury Department, as the agency charged with administering the tax laws, must provide seemingly endless guidance to the public on how to comply with these laws. Because they are often regarded as equivalent to statutory law, valid Treasury regulations are the most important form of Treasury guidance. Treasury regulations—both legislative and interpretive—are the most formal type of Treasury guidance and are clothed with congressional delegatory authority. To the extent that these regulations are respected by reviewing courts, the public is assured that compliance with them is the same as complying with the related federal statute. However, if reviewing courts refuse to defer to Treasury regulatory interpretations of tax statutes, public confidence in the Treasury is damaged, as is its ability to administer the tax laws. Conceivably, this increases the likelihood that taxpayers will challenge Treasury regulations in court.

130 Chodorow, *supra* note 128, at 92 n.65.

131 *C.f. id.* at 68 ("Although often promoted as a tool to be used by policy makers, scholars have argued that judges either are or should be guided by economic principles when deciding cases.").

Stare decisis, Latin for "let the decision stand," is a bedrock principle of common law.[132] It provides that, absent powerful justification, courts should follow previous precedent. In *Edwin's, Inc. v. United States*, the Seventh Circuit had previously determined reasonable compensation using multiple objective factors.[133] Thus, *Exacto Spring* deviates from stare decisis.

Stare decisis reflects two key policy concerns.[134] First, judicial decisions only provide guidance to citizens structuring their affairs and to litigants preparing for trial if courts follow them.[135] Second, respecting previous judicial decisions allows law to develop incrementally.[136] Once *Exacto Spring* was on the books, the first policy concern was ameliorated in the Seventh Circuit, but remains germane for other courts.

Regarding the second policy concern, when the Seventh Circuit issued *Exacto Spring*, courts had been wrestling with reasonable compensation for around seventy years.[137] The Tax Court had penned several dozen opinions regarding the issue, and most Circuits had dealt with the issue a number of times.[138] While courts may have differed slightly regarding the factors they applied, they had reached a consensus that (1) section 162 and its underlying regulations give rise to a dual subjective "intent" test and objective "amount" test, and (2) the "amount" test should be implemented using multiple objective factors.[139]

Judge Posner is quite knowledgeable regarding tax law.[140] However, no amount of technical knowledge can replace the collective practical wisdom of Tax Court judges. They typically practice tax law for decades in private practice, government service, or both prior to their court appointment.[141] Upon

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132 Kenneth J. Schmier & Michael K. Schmier, *Has Anyone Noticed the Judiciary's Abandonment of Stare Decisis?*, 7 LAW & SOC. CHALLENGES 233, 234–35 (2005).

133 Edwin's, Inc. v. United States, 501 F.2d 675, 677 (7th Cir. 1974).

134 Reasons courts should respect the views of predecessors include: (1) efficiency, (2) humility, (3) equal treatment, and (4) "only by following the reasoning of previous decisions can courts provide guidance for the future . . . ." Daniel A. Farber, *The Rule of Law and the Law of Precedents*, 90 MINN. L. REV. 1173, 1177–79 (2006); *see also* Earl Maltz, *The Nature of Precedent*, 66 N.C. L. REV. 367, 368–72 (1988).

135 Maltz, *supra* note 134, at 328.

136 *Id.* at 371–72.

137 *See, e.g.*, Tumwater Lumber Mills Co. v. Comm'r, 65 F.2d 675, 677 (9th Cir. 1933).

138 *See, e.g.*, Dexsil Corp. v. Comm'r, 147 F.3d 96, 96 (2d Cir. 1998); Owensby & Kritikos, Inc. v. Comm'r, 819 F.2d 1315, 1315 (5th Cir. 1987); Elliotts, Inc. v. Comm'r, 716 F.2d 1241, 1245 (9th Cir. 1983); Edwin's, Inc. v. Comm'r, 501 F.2d 675, 675 (7th Cir. 1974); Mayson Mfg. Co. v. Comm'r, 178 F.2d 115, 115 (6th Cir. 1949).

139 *Dexsil*, 147 F.3d at 100.

140 Chodorow, *supra* note 128, at 72.

141 David Laro, *The Evolution of the Tax Court as an Independent Tribunal*, 1995 U. ILL. L. REV. 17, 24 (1995).

appointment, they serve fifteen year terms,[142] during which they typically preside over several cases involving reasonable compensation and other valuation issues.[143] Tax Court expertise is so well recognized that many scholars argue its legal tax interpretations should be afforded a heightened standard of review.[144]

In sum, when the Seventh Circuit issued *Exacto Spring*, adequate reasons were not extant to abandon multiple objective factors analysis, which reflected the collective practical wisdom of dozens of Tax Court judges and had been uniformly followed in all circuits (including the Seventh).

IV. *EXACTO SPRING* IS GROUNDED UPON QUESTIONABLE BEHAVIORAL ASSUMPTIONS

Exacto Spring ignores a multitude of social science theories that potentially are as equally applicable as Law and Economics. In *Menard*, Judge Posner focused on the risk inherent in Mr. Menard's compensation,[145] and clearly, an economic theoretical framework informed Posner's perspective.[146] In a recent article in the *Journal of Institutional Economics*, Posner explains this perspective.[147] He states: "[O]rganization economics emphasizes the relation between organizational structure and compensation systems, on the one hand, and innovation, the management of information flows, agency costs, and efficiency in general, on the other hand."[148] The *Journal* article articulates Posner's keen endorsement of organization economics and his support for the Law and Economics interface.

In Posner's view, the law and economics interface is pragmatic. Posner writes:

> [W]hile pragmatist philosophers do not think that scientific theories can be shown to embody final truths about the structure of the

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142 I.R.C. § 7443(e) (2011).

143 *See generally* Thomas D. Greenaway, *Choice of Forum in Federal Civil Tax Litigation*, 62 TAX LAW. 311 (2009) (discussing Tax Court operations).

144 *See generally* Andre L. Smith, *Deferential Review of Tax Court Decisions of Law: Promoting Expertise, Uniformity, and Impartiality*, 58 TAX LAW. 361 (2005).

145 Menard, Inc. v. Comm'r, 560 F.3d 620, 626 (7th Cir. 2009) ("Of particular importance to this case is the amount of risk in the compensation structure.").

146 And so, for example, he refers to Easterbrook and Fischel's text on the economic structure of corporate law. *Id.*; *see generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991). Easterbrook's and Fischel's text has been critiqued by Kent Greenfield in "The Failure of Corporate Law." *See generally* KENT GREENFIELD, THE FAILURE OF CORPORATE LAW (2006).

147 Richard Posner, *From the New Institutional Economics to Organization Economics: With Applications to Corporate Governance, Government Agencies, and Legal Institutions*, 6 J. INST. ECON. 1 (2010).

148 *Id.* at 2.

> universe, they do not doubt the utility of such theories. It is no more unpragmatic for judges to use economics to help them reach a decision than it is for them to use chemistry, the findings of cognitive psychology, or actuarial computation.[149]

He goes on to say that his support for the Law and Economics interface is pragmatic and empiricist and that economic tools of analysis promote efficiency.[150] Despite Posner's disavowal of final truths and his focus on economics as merely one theory that informs the law, we think that Posner uses organization economics to the exclusion of other available organizational theories. Alternatives to organization economics are available.

What are these alternatives, and where might we find them? As an expert of new institutional economics and transaction cost economics, Oliver Williamson is mentioned in Posner's organization economics article.[151] Williamson himself, a 2009 winner of the Nobel Memorial Prize in economics, provides a survey of organization theory alternatives.[152] Alternatives include resource dependence theory and the anthropological and symbolic perspectives.

The first alternative is resource dependence theory as advocated by Jeffrey Pfeffer.[153] In many ways, the predictions of resource dependence theory are similar to those of transaction cost economics. However, as explained by Pfeffer, resource dependence theory emphasizes that (1) organizations and people within them are interdependent with other organizations and with other people; and (2) due to interdependence, understanding social context is critical.[154] Hence, organizations and the people within them will seek relationships with others and be dependent upon others in order to obtain needed resources. More specifically, a compensation structure results from a social comparison process. According to Pfeffer, seniority has been shown to be more related to compensation than performance.[155] Furthermore, according to Pfeffer, "individuals prefer more equal distributions of wages or other organizational rewards than a principle of equity or proportionality implies, in which

149 RICHARD POSNER, LAW, PRAGMATISM, AND DEMOCRACY 77 (2003).

150 *Id.* at 77–78.

151 *Id.* at 1–2.

152 OLIVER E. WILLIAMSON, ORGANIZATION THEORY: FROM CHESTER BARNARD TO THE PRESENT AND BEYOND 6 (Oliver E. Williamson ed., 1995).

153 Jeffrey Pfeffer, *Incentives in Organizations: The Importance of Social Relations*, *in* ORGANIZATION THEORY: FROM CHESTER BARNARD TO THE PRESENT AND BEYOND 72, 72 (Oliver E. Williamson ed., 1995).

154 *Id.*

155 *Id.* at 79.

individuals are compensated strictly in proportion to their performance . . . ."[156] Resource dependence theory would probably de-emphasize a single test, such as the independent investor test, and instead emphasize the multiple factors of *Mayson Manufacturing*[157] or *Elliotts*[158] because such factors recognize interdependence and context. Moreover, the emphasis upon interdependence and social context points to the importance of stare decisis. As Posner himself explains, "the constraining effect of precedent comes not from the fact that stare decisis is a sound policy but from the fact that a judge's influence is dependent to a significant degree on his decisions being treated as precedent by other judges."[159] In other words, the policy of stare decisis recognizes that organizations or institutions and the people within them are interdependent.

More broadly, resource dependence theory points to the needs of the whole: the whole organization and the whole society. Consideration of the needs of the whole contrasts with "methodological individualism." As described by Mary Douglas, whose work is included among the organization theory alternatives,[160] methodological individualism starts with the rational actor who is "sovereign over his own choices"; this contrasts with an anthropological perspective.[161] As Douglas explains, methodological individualism ignores social influence. Douglas acknowledges Williamson's theory of the firm, which is a "whole," but Douglas points out that Williamson "has the same representative rational individual marching into one kind of contract or refusing to renew it . . . ."[162] As an alternative to methodological individualism, Douglas proposes an anthropological argument: "What the individual is going to want is not entirely his own idea, but consists largely of a set of desires that the social environment inspires in him."[163] Douglas urges that dimensions of culture be included in theories of organizations and their actors. The point is that, as an alternative to organization economics, Douglas' anthropological perspective suggests that a single test, such as the independent

156 *Id.* at 85.

157 Mayson Mfg. Co. v. Comm'r, 178 F.2d 115, 119 (6th Cir. 1949).

158 Elliotts, Inc. v. Comm'r, 716 F.2d 1241, 1244–45 (9th Cir. 1983).

159 Posner, *supra* note 147, at 26–27.

160 Mary Douglas, *Converging on Autonomy: Anthropology and Institutional Economics*, *in* ORGANIZATION THEORY: FROM CHESTER BARNARD TO THE PRESENT AND BEYOND 98, 98 (Oliver E. Williamson ed., 1995).

161 *Id.* at 100.

162 *Id.* at 102.

163 *Id.*

investor test, is inappropriate as it ignores a possible *set* of culturally influenced desires and constraints.

Organization economics can be critiqued from yet another perspective: the non-rational, symbolic perspective. Richard Scott, whose work is included in Williamson's text, recognizes the "importance of economic incentives," but he argues that stronger incentives are symbolic incentives.[164] Briefly, he means that leadership is its own reward and that leaders manipulate symbols.[165] Referring to the work of Chester Barnard, Scott says that symbols elicit commitment of organizational actors; organizational leaders, such as Mr. Menard, are rewarded by the commitment of the organizational actors.[166] In addition, from Scott's perspective, the independent investor test could be considered symbolic in this sense: "[S]ymbols also function in organizations to provide an externally devised cognitive framework, allowing conforming organizations to constitute themselves as rational actors, borrowing meaning and garnering legitimacy and support from their environment."[167] In the sense of an "externally devised cognitive framework," return on equity becomes symbolic because a return on equity *legitimizes* compensation, even though return on equity would not necessarily *justify* compensation.[168]

In sum, the preceding paragraphs have provided some examples of alternative organization theories. More examples are possible. The point is this: organization economics is merely one organization theory.

V. *EXACTO SPRING* CREATES MORE FODDER FOR CONFUSION THAN USING MULTIPLE OBJECTIVE FACTORS[169]

The general formula for return on equity is income divided by equity.[170] While application of return on equity may have

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164 Richard Scott, *Symbols & Organizations: From Barnard to the Institutionalists*, *in* ORGANIZATIONAL THEORY: FROM CHESTER BARNARD TO THE PRESENT AND BEYOND 38, 39–41 (Oliver E. Williamson ed., 1995).

165 *Id.* at 40–42.

166 *Id.*

167 *Id.* at 51.

168 *Id.* at 49.

169 We are not alone in many of our opinions expressed in this section. *See, e.g.*, Hathaway, *supra* note 12, at 924; Moran, *supra* note 4, at A-17–A-18. Chodorow, *supra* note 128, notes that "any purported efficiency gains associated with using economics-based tests may be illusory, especially where the test creates an overbroad and rebuttable presumption." Chodorow, *supra* note 128, at 71. Chodorow provides an excellent discussion of the conceptual fallacies (for example, assumption of bilateral monopoly) and practical difficulties (for example, future parties will likely manipulatively alter future behavior) inherent in the *Exacto Spring* approach. *Id.* at 89–102.

170 JOHN HUGHES, FRANCES AYRES & ROBERT HOSKIN, FINANCIAL ACCOUNTING: A

appeared straightforward in *Exacto Spring*, in actuality the formula is laden with questions ripe for argument. Several cases have wrestled with these questions and arrived at no settled answers.[171]

After *Exacto Spring*, parties in the Seventh Circuit have apparently perceived that their case will hinge upon return on equity. In other circuits, parties have apparently perceived a material possibility their court will adopt the *Exacto Spring* approach and their case will hinge upon return on equity.[172] Consequently, cases have often veered into arcane economic questions with extensive, highly technical, and quite partisan expert testimony. For example, in *Brewer Quality Homes* the Tax Court and the Fifth Circuit wrestled with the merits of the Capital Asset Pricing Model and weighted average cost of capital; the Tax Court also grappled with whether an equity risk adjustment, size adjustment, and company-specific risk adjustment should be made to the risk-free rate of return.[173] In *Wechsler & Co., Inc. v. Commissioner*, the Tax Court considered adjusting cost of common stock equity using a beta (measure of risk comparing a stock's volatility to that of the general market) representing the median beta for six "smaller" publicly traded broker-dealers.[174] In *Menard*, the Tax Court waded into issues of comparative proxy statement compensation, periodicity, transfer restrictions, vesting periods, risk of forfeiture, discount for aversion risk, Financial Accounting Standard 123, etc.[175]

Among the issues that commonly arise when applying return on equity are the following:

VALUATION EMPHASIS 174 (Mark Bonadeo et al. eds., 2005). In practice, parties often modify the definition of income and equity to suit their purposes. *Id.*

171 *Compare* Metro Leasing & Dev. Corp. v. Comm'r., 376 F.3d 1015, 1019 (9th Cir. 2004) (applying the multi-factors cited in prior cases), *with* Menard, Inc. v. Comm'r., 560 F.3d 620 (7th Cir. 2009) (applying the Tax Court's "independent investor" test).

172 *See, e.g.*, Dexsil Corp. v. Comm'r., 147 F.3d 96, 101 (2d Cir. 1998) (remanding decision for Tax Court's failure to make a finding as to whether an independent investor would have approved the salary payments at issue); Labelgraphics, Inc. v. Comm'r., 221 F.3d 1091, 1100 (9th Cir. 2000) ("benchmarking an independent investor's expectations" while applying five-factor analysis).

173 Brewer Quality Homes, Inc. v. Comm'r, 86 T.C.M. (CCH) 29, 34–44 (2003), *aff'd*, 122 F. App'x 88 (5th Cir. 2004). For example, for company-specific risk adjustment, the taxpayer's expert argued for a negative 2.5% risk adjustment due to minimal business and financial risk, while the Service's expert argued for a positive 5% risk adjustment due to the taxpayer's size (as measured by annual sales), industry risks, lack of management depth, and the competitive nature of the taxpayer's business. *Id.* at 34–38.

174 Wechsler & Co., Inc. v. Comm'r, 92 T.C.M. (CCH) 138, 154 (2006).

175 Menard, Inc. v. Comm'r, 88 T.C.M. (CCH) 229, 239–43 (2004), *rev'd*, 560 F.3d 620 (7th Cir. 2009). The Tax Court also wrestled with several of these issues in *Miller & Sons Drywall, Inc. v. Commissioner*, 89 T.C.M. (CCH) 1279, 1283–88 (2005), and *Wechsler & Co., Inc. v. Commissioner*, 92 T.C.M. (CCH) 138, 144–53 (2006).

First, which year(s)' return on equity is relevant? Return on equity for the year(s) at issue, the recent past, the officer's tenure, or the corporation's entire life?[176] The answer is not clear and may differ among cases.[177] A related question is whether to examine return on equity for each year separately or in the aggregate?[178]

Second, what is "income?" Should the parties use financial income per Generally Accepted Accounting Principles, taxable income, or income adjusted to better reflect economic reality?[179] Subtract taxes, interest cost, or cost of equity? Use consolidated or unconsolidated income? Use income per se or dividends plus stock appreciation?[180]

Third, what is "equity?" Should the parties use accounting book equity? If yes, use initial capital contribution, beginning equity, ending equity, average equity, or equity otherwise determined?[181] Include funds in form "borrowed" from the officer that are in substance capital contributions?[182] What should be done if equity is negative?

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176 For example, the Tax Court struggled with this issue in *Miller & Sons Drywall*, 89 T.C.M. (CCH) at 1286–88.

177 Courts have focused primarily upon return on equity for the years at issue. *See, e.g.*, B & D Found., Inc. v. Comm'r, 82 T.C.M. (CCH) 692, 707–10 (2001); Labelgraphics, Inc. v. Comm'r*,* 76 T.C.M. (CCH) 518, 520–22 (1998), *aff'd*, 221 F.3d 1091 (9th Cir. 2000). In *H & A Int'l Jewelry, Ltd. v. Commissioner*, 74 T.C.M. (CCH) 915, 922 (1997), the Tax Court noted: "Since a board makes its bonus decisions from year to year, return on equity may also be examined from year to year. Thus, a strong return in 1 year does not guarantee board approval of bonuses in the next year, especially if there are financial reverses the second year." In *B & D Foundation*, 82 T.C.M. (CCH) at 709, the Tax Court noted that including a corporation's initial years may skew average return on equity if the initial investment was relatively small. The Ninth Circuit noted similarly in *Labelgraphics, Inc. v. Commissioner*, 221 F.3d 1091, 1099–1100 (9th Cir. 2000).

178 This issue arose in *Brewer Quality Homes v. Commissioner*, 86 T.C.M. (CCH) 29, 39–41 (2003), *aff'd*, 122 F. App'x 88 (5th Cir. 2004). The most common practice is to use moving averages over a period of time. Bruce R. Ellig, *Board Critical Issues in Executive Pay*, *in* THE COMPENSATION HANDBOOK 433, 439–40 (5th ed. 2008).

179 This issue arose in *Wechsler & Co.*, 92 T.C.M. (CCH) at 144–45.

180 Measuring stock appreciation entails valuing it at the beginning and end of the relevant period. This imports into reasonable compensation cases all the valuation problems encountered when closely-held companies are valued for estate tax purposes. Chodorow, *supra* note 128, at 100.

181 Because return on equity pertains to a *period* of time (not an instant in time), using average equity over the period is conceptually most correct. However, courts have not always followed this practice. In *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1247–48 (9th Cir. 1983), the Ninth Circuit used end of year equity. Whether beginning, ending or average equity is used can make a material difference. In *E.J. Harrison & Sons, Inc. v. Commissioner*, 86 T.C.M. (CCH) 240, 253 n.6 (2003), the Tax Court noted that using beginning, ending, and average book equity yielded 22%, 12.3% and 7.4% return on equity, respectively.

182 In *M. & E. Shindler, Inc. v. Commissioner*, 63 T.C.M (CCH) 3039, 3039-7 (1992), the Tax Court included funds "borrowed" from officers in equity. In *PMT, Inc. v. Commissioner*, 72 T.C.M. (CCH) 5, 13 (1996), the court noted the question of whether loans from officers should be included in equity.

Or should the parties use fair market value of company stock (beginning, ending, or average)?[183] This value would better represent the opportunity cost of investment.[184] However, it would render relevant everything from the macroeconomic environment to office furniture value, and would import an abundance of technical finance and economic questions. For example, in *Brewer Quality Homes*, the Tax Court valued equity using fair market value; it wrestled for pages and pages with (1) whether to use three times "owners' discretionary cash flow . . ." or five times "earnings before interest (net of interest income and interest expense) and taxes (Federal income taxes), or EBIT [Earnings Before Interest and Taxes]," and (2) how to determine the "cost of capital."[185]

Fourth, what is an *acceptable* return on equity? In *Brewer Quality Homes*, the Tax Court looked to the "rate of return that an investor would expect to realize from an investment in a company such as the taxpayer, taking into account the appropriate risk and performance characteristics of the taxpayer."[186] This definition makes relevant everything about the taxpayer and its operational environment. It also requires identification of comparable companies[187] and raises many technical questions.

Fifth, do the parties adjust for the taxpayer's leverage?[188] Companies with high debt-to-equity ratios will experience heightened return on equity *vis à vis* companies with lower debt-

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183 *E.J. Harrison*, 86 T.C.M. (CCH) at 253 n.6.

184 In *Metro Leasing & Dev. Corp. v. Commissioner*, 81 T.C.M. (CCH) 1644, 1650 (2001), *aff'd*, 376 F.3d 1015 (9th Cir. 2004), the taxpayer argued return on equity should focus on appreciation of assets, including unrealized appreciation of marketable securities and real estate. The Tax Court noted both the difficulties of measuring appreciation and the questionable assumption of attributing appreciation to officer abilities and efforts. *Id.*

185 Brewer Quality Homes, Inc. v. Comm'r, 86 T.C.M. (CCH) 29, 43–46 (2003), *aff'd*, 122 F. App'x 88 (5th Cir. 2004). *See generally* William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19(3) J. FIN. 425 (1964) (providing a model for calculating cost of capital (for example, discount rate) to use in firm valuation. Its parameters are firm and market specific, which makes accurate estimation difficult and consensus regarding appropriate inputs unlikely); David W. Mullins, Jr., *Does the Capital Asset Pricing Model Work?*, 60 HARV. BUS. REV. 105, 105–13 (Jan.–Feb. 1982).

186 Brewer Quality Homes, Inc. v. Comm'r., 86 T.C.M. 29, 44 (2003), *aff'd*, 122 F. App'x 88 (5th Cir. 2004).

187 *See, e.g.*, Labelgraphics v. Comm'r, 76 T.C.M. (CCH) 518, 526–27 (1998), *aff'd*, 221 F.3d 1091 (9th Cir. 2000). *See also* Ted Buyniski & Marvin A. Mazer, *Executive Compensation Strategy*, *in* THE COMPENSATION HANDBOOK 311, 316–17 (5th ed. 2008) (offering guidance for peer group selection based on size, performance, business industry, and economics. The authors acknowledge that for many firms discovering a peer group of reasonable size will be very difficult and *ad hoc* adjustments may be necessary.).

188 The Tax Court noted this issue in *Foos v. Commissioner*, 41 T.C.M. (CCH) 863, 875–83 (1981).

to-equity ratios when times are good, but the reverse is also true.[189]

Sixth, is it valid to assume that a satisfactory return on equity is primarily attributable to officer performance?[190]

Seventh, if return on equity is unsatisfactory, do key officers receive no compensation?[191]

Eighth, if a corporation has more than one key officer, does return on equity reveal the reasonableness of compensation among officers?[192]

Finally, is return on equity the best measure of firm performance?[193] Today, it is not necessarily viewed as the most conceptually sound measure of firm performance.[194]

Although return on equity often enters into multiple objective factors analysis and so these issues could arise anyway, the *Exacto Spring* approach transmutes the issues into the crux of the case. This transmutation makes parties more likely to bring out the heavy artillery of partisan experts who render highly technical and arcane testimony. While parties often introduce expert testimony regarding multiple objective factors analysis, such testimony is typically less technical and is related to matters more within the typical judge's realm of knowledge.

Currently, parties have to address both approaches. In circuits other than the Seventh, in the event the court follows *Exacto Spring*, parties must address return on equity. In the Seventh Circuit, parties must address multiple objective factors

189 K. R. SUBRAMANYAM & JOHN J. WILD, FINANCIAL STATEMENT ANALYSIS 463–65 (10th ed. 2009).

190 Haffner's Serv. Stations, Inc. v. Comm'r, 83 T.C.M. (CCH) 1211, 1223 n.15 (2002), *aff'd*, 326 F.3d 1 (1st Cir. 2003). In the one case we located in which the taxpayer argued it *overpaid* its officers (and hence part of what it originally characterized as compensation was unreasonable), the taxpayer was quick to argue that its excellent financial performance was mostly attributable to a fortuitous regional boom in its industry (construction) and the hard work of other employees. Summit Sheet Metal Co. v. Comm'r, 72 T.C.M. (CCH) 1606, 1610–12 (1996).

191 The Ninth Circuit in *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1247 n.5 (9th Cir. 1983), notes that occasionally compensation may be reasonable even if return on equity is unsatisfactory or even negative.

192 The Tax Court noted this issue on remand in *E.J. Harrison & Sons, Inc. v. Commissioner*, 91 T.C.M. (CCH) 1301, 1303 (2006), *aff'd*, 270 F. App'x 667 (9th Cir. 2009).

193 In *E.J. Harrison*, 86 T.C.M. (CCH) 240, 253 n.6 (2003), the Tax Court noted that, because the taxpayer's equity had remained essentially constant while its sales and assets increased, return on assets or return on sales would likely be a superior measure of performance in that case.

194 The most contemporary measure of investment performance is Economic Value Added. Economic value added = after-tax operating profit – [(total assets – current liabilities) * weighted average cost of capital]. STEVEN R. JACKSON, ROBY B. SAWYERS & J. GREGORY JENKINS, MANAGERIAL ACCOUNTING: A FOCUS ON ETHICAL DECISION MAKING 417–18 (Rob Dewey ed., 5th ed. 2009).

analysis in case the court holds the taxpayer's return on equity was unsatisfactory or was not attributable solely to officer(s).

Finally, the Service has other weapons available to disallow unreasonable compensation. For example, the Service could use the section 162 "ordinary and necessary" provision, section 482, or the substance over form doctrine.[195] All of these generate messy facts and circumstances battles. What is to prevent the Service from using these weapons if courts adopt the *Exacto Spring* approach?

VI. OUR THOUGHTS AND SUGGESTIONS

A. Appellate Courts Should Review Trial Courts' Selection of Relevant Reasonable Compensation Factors Using a Clearly Erroneous Standard

At the appellate level, trial courts' factual findings are properly overturned only if "clearly erroneous"; their legal conclusions are properly reviewed without deference (that is, *de novo*).[196] However, there is not simply a continuum of issues ranging from purely factual to purely legal. For example, "evaluative determinations" have no home in such a continuum.[197]

"Reasonable" issues, including the reasonable compensation issue, are evaluative determinations; such issues are not properly

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195 Although cases have held I.R.C. § 482 does not apply in the context of a corporation and an employee working solely for that corporation, *Foglesong v. Commissioner*, 691 F.2d 848 (7th Cir. 1982), the I.R.C. § 482 regulations were subsequently amended to provide "[e]mployment for compensation will constitute a separate trade or business from the employing trade or business." Treas. Reg. § 1.482-1(i)(2) (2011). *See also* COLE, *supra* note 114, at § 2.04, n.12.

196 Anderson v. City of Bessemer City, N.C., 470 U.S. 564, 573 (1985).

197 Randall H. Warner, *All Mixed up About Mixed Questions*, 7 J. APP. PRAC. & PROCESS 101, 104–09 (2005). The article provides the following examples of evaluative determinations.

> For example, in a negligence case involving stipulated historical facts—that is, the parties agree about what happened, but disagree about whether the defendant's conduct was reasonable—the jury's reasonableness determination is neither factual nor legal. It is not deciding what happened, since that is stipulated. And it is not deciding rules that apply for all similarly situated people. It is just deciding whether one person's conduct was reasonable in a specific circumstance.
>
> Similarly, a jury's decision to award $1 million in damages for pain and suffering is neither fact nor law, nor anything in between. It is a different kind of decision altogether, one in which the jury is neither determining what happened (a question of fact) nor fixing a generally applicable rule (a question of law), but is prescribing the appropriate result in one specific case.

Id. at 108. As noted by the article, evaluative determinations are found everywhere in the law (for example, negligence in tort law and probable cause in criminal procedure).

always reviewed deferentially or *de novo*.[198] Rather, their standard of review is based on a policy choice concerning the judicial actor better positioned to decide the particular issue.[199]

Appellate courts have treated composition of the factors used to determine reasonable compensation as a legal question reviewable *de novo*.[200] Nevertheless, they have treated determination of the ultimate fact of the amount of reasonable compensation as a factual question reviewable only for clear error.[201] This disparate treatment seems logically inconsistent. By deferring to trial courts' determination of the amount of reasonable compensation, appellate courts implicitly acknowledge that trial courts are better positioned to make this evaluative determination. If trial courts are better positioned to determine the amount of reasonable compensation, surely they are also better positioned to select the factors relevant to such determination.

Further, appellate courts already show deference to trial courts' *weighting* of reasonable compensation factors differently in different cases, but there is no logical distinction between determining that a given factor will receive a very high or very low weight in different cases and determining that the factor is relevant in some cases and irrelevant in other cases.[202]

In sum, trial courts are better positioned to select relevant reasonable compensation factors. Such selection is integral to determining the amount of reasonable compensation, an inherently factual determination that appellate courts concede is properly the province of trial courts. Thus, appellate courts should overrule trial courts' selection of relevant reasonable compensation factors only if it leads to clearly erroneous determination of ultimate fact (the amount of reasonable compensation).

B. A Few Additional Thoughts

We believe it unlikely that an independent company owner would agree to a contract embodying the *Exacto Spring* approach. Such a contract would allow the officer to draw out any amount

198 Warner, *supra* note 197, at 130.

199 *Id.*

200 Dexsil Corp. v. Comm'r, 147 F.3d 96, 100 (2d Cir. 1998).

201 Labelgraphics, Inc. v. Comm'r, 221 F.3d 1091, 1094 (9th Cir. 2000).

202 *See, e.g.*, Leonard Pipeline Contractors, Ltd. v. Comm'r, 142 F.3d 1133, 1135 (9th Cir. 1998) ("Despite the difficulties of determining what is reasonable compensation, it is the obligation of the Tax Court to spell out its reasoning and to do more than enumerate the factors and leap to a figure intermediate between petitioner's and the Commissioner's.").

of compensation, no matter how high, as long as return on equity is left at a certain minimal level.

More likely, an officer and independent company owner would agree as follows.[203] First, the officer will receive minimal fixed compensation, even if pre-compensation net income is negative. Next, if net income (after officer minimal fixed compensation) is positive, the company owner will receive a minimal return on their invested capital. If net income exceeds that needed to provide the minimal return on owner invested capital, the officer and company owner will share the "bounty."[204] Under the *Exacto Spring* approach, *all* the bounty would be allocated to the officer. While profit sharing plans entitling management to a share of the bounty are common, we are aware of no independent company owner agreeing to a compensation plan granting management most, much less all, of it.[205]

Allocating all the bounty to the officer implicitly presumes that *only* the officer could have steered the taxpayer to a bountiful performance.[206] We believe this is an erroneous presumption of bilateral monopoly.[207] Occasionally, the officer

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203 To accord with real world business practice, contingent compensation formulas must be agreed to before the period in question. Likewise, Treas. Reg. § 1.162-7(b)(2) provides that to be reasonable contingent compensation it must represent a "free bargain between the employer and the individual made *before* the services are rendered" Treas. Reg. § 1.162-7(b)(2) (2011) (emphasis added). However, *Exacto Spring* does not appear to limit its attempted coinage of the return on equity approach to *ex ante* compensation formulas.

204 CEO cash bonus compensation is on average seventy-five percent of base salary. Lower executive bonus compensation is significantly less than fifty percent and declines as one moves down the organization chart. Amuso & Knopping, *supra* note 126, at 212.

205 *See generally* Robert Masternak, *Gainsharing or Profit Sharing*, *in* THE COMPENSATION HANDBOOK 277 (5th ed. 2008).

206 The Tax Court noted in *PMT, Inc. v. Commissioner*, 72 T.C.M. (CCH) 5, 28 (1996), that this assumption is likely not valid.

207 Chodorow, *supra* note 128, at 97, notes the Seventh Circuit may have erroneously grounded *Exacto Spring* upon the assumption of a bilateral monopoly and states as follows:

> While it might theoretically be reasonable for an investor to pay 100 percent of profits above his expected return to an executive if he has no other means of obtaining his expected return, the market drives down the price an investor has to pay. It would be unreasonable for an investor seeking to maximize his wealth to pay 100 percent of those excess profits to one executive, if another would agree to take only fifty percent. Even if this second executive were to generate a smaller gross return than the first, if his share of the profits is small enough, the investor will still be better off by hiring the second executive. Thus, the premise that a hypothetical reasonable investor would agree to pay an above-market salary may be faulty, and the conclusion that an employee/owner's salary was reasonable because it fell within the range predicted by a model that eliminates the market may not be warranted.

The Tax Court noted in *Guy Schoenecker, Inc. v. Commissioner*, 70 T.C.M. (CCH) 1303, 1312 (1995), that while "it is difficult to determine what an independent investor would expect from the risk of his funds in a business such as [the taxpayer's] . . . it is reasonable to assume that an independent investor would be unwilling for an officer to realize

may have technical expertise, supplier and customer relationships, or the like, without which the taxpayer simply could not function. But usually the taxpayer could function without the officer. Pre-compensation net income might be lower without the officer, but such diminution could potentially be more than offset by reduced salary cost.[208]

If the bounty is attributable to intangibles (on or off the balance sheet), its division would depend upon who owns or controls the intangibles. For example, if certain customers would cease purchasing from the company if the officer left, this "customer list" intangible would provide the officer with bargaining leverage to obtain a larger share of the bounty.

Courts have occasionally allowed compensation to be increased for the value of intangibles such as customer lists, unique processes, etc.[209] Issues frequently skipped include: (1) who owns or controls the intangibles,[210] and (2) whether the intangibles would have value if the officer left the corporation. In our view, if a corporation uses intangibles owned or controlled by an officer, the officer should receive more of the bounty. However, if the corporation owns or controls intangibles that would remain valuable if the officer were absent, the corporation should receive more of the bounty.[211]

C. A Few Suggestions

Additional regulatory guidance would better protect closely-held corporations from uncertainty regarding reasonable compensation than would adoption of the *Exacto Spring* approach. Such regulations could prescribe, *inter alia*, methodological guidance similar to the section 482 regulations,[212]

compensation out of line with compensation paid by similar businesses, thus unnecessarily reducing the income produced by the business in which he had invested."

208 The section 162 regulations implicitly acknowledge the ability of market competition to drive down compensation stating "[i]t is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." 26 C.F.R. § 1.162-7(b)(3) (2011).

209 *See, e.g.*, Beiner, Inc. v. Comm'r, 88 T.C.M. (CCH) 297, 307–08 (2004); Mortex Mfg. Co., Inc. v. Comm'r, 67 T.C.M. (CCH) 2412, 2422 (1994).

210 If an officer previously developed intangibles but was not adequately compensated therefore, this raises a pay for past services issue. Compensation intended to compensate an officer for previous under-compensation can be "reasonable." Lucas v. Ox Fibre Brush Co., 281 U.S. 115, 119–20 (1930). However, the taxpayer must establish (1) the insufficiency of the officer's compensation in the previous year(s), and (2) the amount of the current year's compensation intended as compensation for that underpayment. Pacific Grains, Inc. v. Comm'r, 399 F.2d 603, 606 (9th Cir. 1968).

211 Regardless of who owns or controls intangibles, if they increase corporate earnings then compensation tied to earnings will also increase.

212 The arm's length transaction standard of I.R.C. § 482 has a "close analytic

mandatory documentation regarding the taxpayer's method of determining compensation,[213] and procedures for pre-filing agreements regarding reasonable compensation.[214]

The impact of intangibles on reasonable compensation also warrants additional regulatory guidance.[215] We believe courts should more deliberately identify and address the impact of intangibles on reasonable compensation. However, valuing intangibles entails thorny measurement questions. For example, many intangibles are inextricably tied to other intangible or tangible assets, making disaggregated valuation exceedingly difficult.[216] This valuation issue is likely one reason firms with high amounts of intangibles are more likely to use bonus structures with earnings rather than return based benchmarks.[217] However, crafting of useful intangible valuation guidance is possible.[218]

CONCLUSION

Courts have been reluctant to follow *Exacto Spring*'s return on equity approach in reasonable compensation cases.[219] We agree with their reluctance. Multiple objective factors analysis better accords with section 162, better implements applicable regulations, is more consonant with collective judicial wisdom,

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kinship" to the reasonable compensation issue. Stumpff, *supra* note 1, at 398 n.80. In *Miller & Sons Drywall, Inc. v. Comm'r*, 89 T.C.M. (CCH) 1279, 1282 (2005), a reasonable compensation case, the Tax Court characterized its task as deciding "whether the amount of compensation paid to petitioner's shareholder-employees would have been the same had they engaged in an arm's-length negotiation." The I.R.C. § 482 regulations look to comparable transactions rather than economic theory to determine whether transactions between related parties satisfy the arm's length standard. Treas. Reg. § 1.482-2 (2011).

213 *See* COLE, *supra* note 114, at ch. 20 for a discussion of transfer pricing documentation requirements.

214 *See* COLE, *supra* note 114, at ch. 19 for a discussion of transfer pricing Advance Pricing Agreements.

215 In *Normandie Metal Fabricators v. Commissioner*, 79 T.C.M. (CCH) 1738, 1747 (2000), the Service's expert testified "it is misleading to measure return on equity based on a shareholder's nominal investment in the company because the shareholder may have invested capital or sweat equity and the company may have contributed patents, intellectual property, or other intangibles that do not appear on the balance sheet." Thus, he testified, "the rate of return on equity is best measured by comparing the company's operating return to the fair market value of its operating assets [including intangibles not appearing on the taxpayer's balance sheet]." *Id.*

216 For example, Coca-Cola's brand name and secret formula are seemingly inseparable as distinct assets. When the company tried to use the same brand name with a different formula in the 1980s, sales plummeted and brand value was damaged until the company resumed with the "Classic" formula and eventually cancelled production of "New Coke."

217 Debra L. Krolick, *The Relevance of Financial Statement Information for Executive Performance Evaluation: Evidence from Choice of Bonus Plan Accounting Performance Measures*, 40 INT'L J. ACCT. 115, 125–30 (2005).

218 *See* ALFRED M. KING, FAIR VALUE FOR FINANCIAL REPORTING ch. 6 (2006).

219 Behrens, *supra* note12, at 801–02.

and is more attuned to the manner in which unrelated parties actually determine compensation. A likely more efficacious approach to lessening taxpayer uncertainty regarding reasonable compensation would be issuance of additional regulatory guidance, including methodological guidance (especially regarding intangibles), documentation guidance, and pre-filing agreement procedures.