

Retained Shareholder/Executive Reasonableness of Compensation in the ESOP Sponsor Company

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An otherwise profitable closely held C corporation may be able to minimize its federal income tax liability if it pays a salary or bonus to its employee/shareholders in an amount sufficient to “absorb” all of the taxable income. Whether the C corporation distribution is a salary or a dividend, all such distributions are taxable as ordinary income to the employee/shareholder. However, employee salary or bonus payments are tax deductible to the C corporation. In contrast, shareholder dividends are not tax deductible to the C corporation. So, the taxpayer corporation can reduce its federal income tax expense by characterizing employee/shareholder distributions as salary/bonus rather than as dividends. Accordingly, the Internal Revenue Service often challenges the reasonableness of employee/shareholder (particularly controlling shareholder) compensation during the audit of the closely held C corporation. This discussion summarizes the conclusion of a relevant recent Tax Court judicial decision—with an emphasis on what is called the independent investor test of assessing the reasonableness of employee/shareholder compensation.

INTRODUCTION

There are several instances when the reasonableness of the closely held corporation shareholder/executive compensation may become an issue in an employee stock ownership plan (ESOP) context.

The issue of interest to the ESOP is whether the closely held sponsor company is paying the retained shareholder/executive an above-market or excessively high level of compensation. This becomes a particularly relevant issue when (1) the retained shareholder/executive owns a controlling ownership interest in the sponsor company (often as a member of the close corporation founding family) and (2) the ESOP trust owns a noncontrolling ownership interest in the sponsor company. Some of the instances when the sponsor company’s retained shareholder/executive reasonableness of compensation may affect the ESOP include the following:

1. when the employer corporation board is contemplating the feasibility of an initial ESOP formation
2. when the financial advisor to the to-be-formed ESOP is assessing the employer corporation debt service capacity related to an initial leveraged employer stock purchase
3. when the financial advisor to the to-be-formed ESOP is estimating the fair market value of the to-be-purchased employer stock
4. when the ESOP trustee (or the ESOP legal counsel) is negotiating the terms of an employment agreement with the retained shareholder/executive
5. when the lending institution is negotiating the debt indenture terms and conditions of the sponsor company guarantee of the ESOP employer stock acquisition loan
6. when the ESOP trustee’s financial advisor is assessing the fairness of the employer stock purchase transaction
7. when the ESOP stock acquisition debt is paid off and the retained shareholder/

- executive wants to increase his or her compensation out of the now-available cash flow
8. when the trustee's valuation analyst performs the periodic valuation of the employer corporation stock in order to (a) allocate shares to participant accounts or (b) redeem retiring participants
 9. when the retained shareholder/executive concludes that current employer stock values are inadequate for a stock sale and the shareholder pursues a compensation increase in order to obtain liquidity
 10. when the employer corporation approaches the zone of insolvency (before or after the ESOP stock purchase debt is paid down)

Accordingly, the question of what constitutes retained shareholder/executive reasonable compensation often becomes a contested issue for the closely held sponsor company. This is because the shareholder (particularly an employer corporation controlling shareholder) can often set his or her own salary and bonus without a review by an outside board of directors or by any other independent authority.

In the selection of analytical methods and procedures, ESOP valuation analysts and other financial advisors often rely on federal income tax-related professional guidance to address this issue.

TAX-RELATED PROFESSIONAL GUIDANCE

The Internal Revenue Service (the "Service") focuses on the reasonableness of the compensation paid by closely held C corporations to shareholder/executives. The reason for this Service audit focus is that such a corporation may be able to reduce or eliminate its taxable income simply by increasing the amount of compensation paid to the shareholder/executive. That is, the shareholder/executive can eliminate the taxation on the corporation income simply by paying himself or herself a salary (or bonus) sufficient to absorb most (or all) of the corporation's taxable income. Therefore, in the closely held C corporation audit, the Service will often challenge what it considers to be an unreasonably large shareholder/executive salary, bonus, or other compensation. The Service will typically seek to recharacterize some—or all—of the shareholder/executive compensation as a nondeductible, disguised dividend.

In a recent judicial decision,¹ the U.S. Tax Court articulated five factors that it considered in its determination of the reasonableness of a C

corporation sole shareholder's compensation. The *Multi-Pak Corp.* decision does not relate to an ESOP sponsor company. However, these same five factors could be informative to valuation analysts and other financial advisors assessing the retained shareholder/executive reasonableness of compensation in a closely held ESOP sponsor company.

The two years of 2002 and 2003 were at issue in the *Multi-Pak Corp.* case. In those two years, the subject corporation deducted compensation paid to the sole shareholder/executive in excess of \$2 million each year.

First, this discussion will summarize the five reasonableness of compensation factors considered in the *Multi-Pak Corp.* decision. Second, this discussion will present a simplified illustrative example of the application of the quantitative reasonableness of compensation factors to a hypothetical ESOP sponsor company.

THE FIVE REASONABLENESS OF COMPENSATION FACTORS

The five reasonableness of shareholder/executive compensation factors considered by the Tax Court in the *Multi-Pak Corp.* decision were originally listed by the U.S. Court of Appeals in *Elliotts, Inc.*² And, the *Elliotts, Inc.* decision, in turn, distilled the five factors from a list of eight factors listed in an earlier Court of Appeals decision, *Mayson Manufacturing Co.*³ The eight *Mayson* reasonableness of compensation factors are as follows:

1. the employee's particular qualifications for the job
2. the nature, scope, and extent of the work actually performed by the employee
3. the size and complexity of the subject business enterprise
4. the economic conditions and background of the industry involved
5. the subject company's dividend history
6. comparable salaries paid in the industry
7. the compensation paid to the subject company's other employees
8. the subject employee prior years' compensation (especially for years in which the employee was clearly undercompensated)

The eight *Mayson* factors are often referenced by valuation analysts and other financial advisors. This is because these same eight factors are listed, almost verbatim, in the Internal Revenue Service audit manual.⁴

The *Elliotts, Inc.* (and the *Multi-Pak Corp.*) five reasonableness of compensation factors are listed below:

1. the employee's role in the subject corporation
2. an external comparison with other comparable companies
3. the character and the condition of the subject corporation
4. any potential conflicts of interest
5. the internal consistency of executive compensation practices within the subject corporation

In the *Multi-Pak Corp.* decision, the Tax Court gave considerable weight to the fourth factor—that is, the potential conflicts of interest. In particular, the Tax Court assessed this reasonableness of shareholder/executive compensation factor from the perspective of what valuation analysts typically call the “hypothetical independent investor test.”

In explaining its judicial reasoning, the Tax Court quoted the Ninth Circuit analysis of the reasonableness of compensation issue in the *Elliotts, Inc.* decision as follows: “If the company's earnings on equity after payment of the compensation at issue remain at a level that would satisfy a hypothetical 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.”

APPLYING THE FIVE FACTORS TO THE FACTS OF THE CASE

In its decision, the Tax Court analyzed the specific facts and circumstances of the *Multi-Pak Corp.* case. The Tax Court then weighted each of the five reasonableness of shareholder/executive compensation factors. The Tax Court concluded that:

1. three of the five factors supported the taxpayer contention that the compensation deducted during the subject years was reasonable,
2. one of the five factors was neutral to both parties, and
3. only one of the five factors—i.e., the potential conflicts of interest test—favored the IRS disguised dividend position.

1. The Shareholder/Executive Role in the Subject Corporation and the Services Performed by the Shareholder/Executive

This first factor focuses on the shareholder/executive importance to the success of the subject business enterprise. The Tax Court considerations of this factor included: the employee's position in the subject company, the number of hours that the employee actually worked, and the actual duties performed by the shareholder/executive.

During the subject years, the sole shareholder/executive served as the *Multi-Pak Corp.* president, CEO, and COO. He controlled all aspects of the company operations. He performed all managerial duties. And, he made all personnel decisions. And, he was in charge of price negotiations, product design, machine design and functionality, and company administration.

In 2002, the sole shareholder/executive configured a new warehouse facility to accommodate the subject company's expanding business operations. In doing so, the shareholder/executive: (1) drafted floor plans for the facilities, (2) determined electrical distribution and compressed air filtration system requirements for each room, (3) helped to design the facility lighting system, and (4) designed the warehouse layout and materials flow pattern. The shareholder/executive devoted all of his time to the subject company operations. And, he directly contributed to the company's financial condition.

The Tax Court found that this reasonableness of compensation factor weighted in the corporation's favor.

2. External Comparison—Competitive Compensation Survey Analysis

This second factor compares the subject shareholder/executive compensation with the amounts paid by comparable companies for comparable employee services. Compensation analyst expert witnesses testified on behalf of both parties (the corporation and the IRS) to support their respective analyses of comparable compensation amounts.

Each expert witness compared (1) the shareholder/executive compensation to (2) the amount of compensation paid to allegedly comparable employees at allegedly comparable companies. The objective of the comparison was to determine whether the compensation paid to the shareholder/executive was commensurate with the services he provided to the corporation. However, the Tax Court did not find the extensive compensation survey analyses of either expert witness to be persuasive or reliable.

Therefore, the Tax Court found this reasonableness of compensation factor to be neutral. This factor did not sway the Tax Court's decision in favor of either party.

3. The Character and the Condition of the Subject Corporation

This third factor focuses on the corporation's size as measured by its sales, net income, or shareholder's equity value. This factor considers the complexities of the subject business enterprise. And, this factor contemplates the general economic conditions that may influence the corporation's financial performance.

The Tax Court found Multi-Pak Corp. to be prominent in its industry. Considering its increased owner's equity, revenue, and gross profit, the Tax Court stated that Multi-Pak Corp. was "one of the more successful companies of its kind."

The Tax Court concluded that this reasonableness of compensation factor was in the corporation's favor.

4. Conflicts of Interest—The Hypothetical Independent Investor Test

This fourth factor examines whether a relationship exists between the corporation and the shareholder/executive that would permit the corporation to disguise nondeductible corporate distributions as deductible compensation payments. As mentioned above, the Service believes that close scrutiny is particularly warranted when a shareholder/executive controls the subject corporation.

In keeping with the Ninth Circuit decision in *Elliotts, Inc.*, the Tax Court held that the reasonableness of shareholder/executive compensation in this case should be evaluated from the perspective of a hypothetical independent investor. In the *Elliotts, Inc.* decision, the corporation's average rate of return on equity was 20 percent. In that case, the Ninth Circuit determined that the 20 percent rate of return on equity would satisfy a hypothetical independent investor. In its analysis of the Multi-Pak Corp. returns, the Tax Court determined that the subject corporation's operations resulted in:

1. a 2.9 percent rate of return on equity in 2002 and
2. a -15.8 percent rate of return on equity in 2003, far from the 20 percent rate of return on equity found acceptable in the *Elliotts, Inc.* decision.

Nonetheless, the Tax Court reasoned that a hypothetical independent investor would consider other factors in determining an acceptable rate of return on investment. In particular, the Tax Court concluded that a hypothetical independent investor in Multi-Pak Corp. would note that:

1. the shareholder/executive was instrumental in the financial success and stability of Multi-Pak Corp. and
2. Multi-Pak Corp. had little or no debt outstanding.

Therefore, the Tax Court concluded that (1) a higher level of executive compensation would be merited and (2) a lower rate of return on investment would be expected. This conclusion was due to the relatively low risk associated with an investment in the Multi-Pak Corp. equity. However, the Tax Court agreed with the Service that the negative 15.8 percent rate of return on equity called into question the reasonableness the shareholder/executive compensation for the 2003 year.

Accordingly, the Tax Court concluded that its independent investor test analysis of the conflicts of interest factor (1) favored the corporation for 2002 and (2) favored the Service for 2003.

5. Subject Corporation Internal Consistency of Executive Compensation Practices

This fifth factor considers the consistency with which the corporation's executive compensation policy is applied. According to the *Elliotts, Inc.* decision, evidence of any internal inconsistency in the company's treatment of payments to employees may indicate that the shareholder/executive payments go beyond reasonable compensation. Further, executive bonuses that have not been awarded under a structured formal, consistently applied performance bonus program may be suspect. In addition, evidence of a reasonable, long-standing, consistently applied company compensation plan may be evidence that the shareholder/executive compensation paid in the subject years was reasonable.

In the *Multi-Pak Corp.* instance, the subject corporation had a policy of paying monthly bonuses based on the company's performance and profits each month. The monthly bonuses were paid to the shareholder/executive and to his three sons (who served as managers of the corporation). The Service did not challenge the amount of the compensation paid to the shareholder/executive's sons in the subject years.

The Tax Court weighed the corporation's monthly bonus program against a hypothetical program

where bonuses would be determined at year end, when profitability would be known, and where there would be more temptation to disguise dividends as compensation. The Tax Court concluded that the corporation's monthly bonus policy constituted a consistent compensation plan.

Therefore, the Tax Court concluded that this reasonableness of compensation factor weighted in the corporation's favor.

ILLUSTRATIVE SHAREHOLDER/ EMPLOYEE REASONABLENESS OF COMPENSATION ANALYSIS

The following illustrative example summarizes the quantitative components of a shareholder/employee reasonableness of compensation analysis. In a comprehensive reasonableness of compensation analysis, both the quantitative and the qualitative *Multi-Pak Corp.* factors should be considered. This example and the associated analyses are deliberately simplified. They are presented here for illustrative purposes only.

The Illustrative Fact Set

Omega Construction Corporation ("Omega") is a general contractor of industrial buildings and warehouses. Omega is a regular C corporation for federal income tax purposes. Harry Smith serves as both the president/chief executive officer and the chief marketing officer of the corporation. Smith is also the controlling stockholder of Omega.

In 2010, Omega generated revenue of \$100 million. During that year, the company's average assets were \$50 million. During 2010, Omega paid Smith \$12 million in shareholder/employee compensation. The Omega Construction Corporation ESOP ("the ESOP") is a noncontrolling shareholder in Omega. The ESOP owns its sponsor company equity interest on an unlevered basis. That is, there is no ESOP employer stock acquisition loan.

Omega makes a cash contribution to the ESOP each year at the maximum amount allowable under the Internal Revenue Code. Nonetheless, the employer corporation rarely pays dividends on its common stock. The annual employer stock valuations have concluded value increases at an acceptable rate each year.

However, Harry Smith, the principal stockholder, earns a very generous salary and bonus. The ESOP trustee asked the employer stock valuation analyst to specifically consider if Smith's \$12,000,000 of total compensation in 2010 is reasonable.

In addition to Smith, there are six other Omega corporate officers. Each of these six corporate officers owns a very small percentage of the Omega common stock. Smith negotiates the compensation for each of these six executives in arm's-length negotiations. The valuation analyst, therefore, assumes that the 2010 compensation earned by the six other corporate officers is reasonable. Collectively, these six executives earned \$4,800,000 in salary and bonus in 2010.

In all of the following exhibits, all of the Omega Construction Corporation financial data are hypothetical. In addition, the general contractor industry compensation and other financial data are also made up for illustrative purposes only. Of course, the indicated industry data sources are generally recognized financial and compensation data sources. However, the 2010 financial "data" presented are purely hypothetical, for illustrative purposes only.

The Simplified Illustrative Reasonableness of Compensation Analysis

Exhibit 1 summarizes a simplified salary survey analysis. Such an analysis uses published executive compensation survey data, which are typically presented (1) by size of company and (2) by contractor specialty.

In this particular analysis, the valuation analyst relied on three executive salary surveys: (1) the Economic Research Institute (ERI) Executive Compensation Assessor as of July 1, 2010, (2) the Watson Wyatt Data Services 2010 Top Management Comp Calculator, and (3) the PAS, Inc. Executive Compensation Survey for Contractors (2010 edition).

Exhibit 1 presents a range of the maximum reasonable compensation levels for executives performing comparable duties to the Smith duties at comparable construction companies. Based on the various published salary survey analyses summarized in Exhibit 1, the range of maximum reasonable shareholder/employee compensation for Harry Smith is \$8,850,000 to \$11,020,700.

Exhibit 2 summarizes a simplified financial ratio analysis. Exhibit 2 presents the total reasonable shareholder/employee compensation levels for all of the corporate officers (as a group) of Omega. Exhibit 2 reports illustrative industry financial ratio data from two commonly referenced annual industry analysis publications: (1) the *Almanac of Business and Financial Ratios* and (2) the Risk Management Association *Annual Statement Studies*.

Exhibit 1

Omega Construction Corporation

Reasonableness of Shareholder/Employee Compensation

Salary Survey Analysis

Harry Smith Actual 2010 Compensation	ERI Executive Compensation Assessor [a]			Watson Wyatt Comp Calculator [b]				
	Median	75th Percentile	90th Percentile	Median	7th Percentile	90th Percentile		
	\$	\$	\$	\$	\$	\$		
\$12,000,000	1	2,229,000	3,281,000	4,460,000	1	2,307,600	3,469,100	4,820,000
	2	2,205,000	3,280,000	4,390,000	2	2,215,600	3,255,800	4,472,000
		4,434,000	6,561,000	8,850,000		4,523,200	6,724,900	91,292,000
PAS, Inc. Executive Compensation Survey for Contractors [c]								
	Median	90th Percentile						
	\$	\$						
	1	3,300,000	5,607,000					
	2	3,200,500	5,413,700					
		6,500,500	11,020,700					

Range of Harry Smith Maximum Reasonable Shareholder/Employee Compensation: \$8,850,000 to \$11,020,700

Notes:

- [a] Line 1: SIC code 1541, general contractors - industrial buildings and warehouses, revenue between \$100 and \$150 million, chief executive officer
Line 2: SIC code 1541, general contractors - industrial buildings and warehouses, revenue between \$100 and \$150 million, chief marketing officer
- [b] Line 1: SIC code 1541, general contractors - industrial buildings and warehouses, sales of \$100 million, chief executive officer position.
Line 2: SIC code 1541, general contractors - industrial buildings and warehouses, sales between \$100 million, chief marketing officer position.
- [c] Line 1: SIC code 1541, general contractors - industrial buildings and warehouses, revenue between \$100 and \$150 million, chief executive officer
Line 2: SIC code 1541, general contractors - industrial buildings and warehouses, revenue between \$100 and \$150 million, chief marketing officer

The particular financial ratio analysis presented in Exhibit 2 considers the shareholder/executive compensation levels for all of the subject sponsor company officers as a group. After subtracting the \$4,800,000 officer compensation (other than Smith's compensation), the Exhibit 2 financial ratio analysis presents a residual range of the maximum reasonable shareholder/employee compensation for Smith.

Based on the various financial ratio analyses summarized in Exhibit 2, the maximum range of reasonable shareholder/employee compensation for Harry Smith is \$13,900,000 to \$29,200,000.

Exhibit 3 summarizes a simplified hypothetical independent investor test with regard to the reasonableness of the Harry Smith shareholder/employee compensation. The independent investor test is a single-factor test that is widely relied on by the courts in income tax disputes and in other contested matters related to shareholder/employee compensation.

The hypothetical independent investor test is based on a fair rate of return on capital (typically, owners' equity capital) analysis. Exhibit 3 presents:

1. an estimated value for the Omega total owners' equity at the end of 2010 and
2. a hypothetical independent investor's required fair rate of return on invested equity capital.

Subtracting the independent investor's required return on equity capital from the construction company's pretax income (prior to officer compensation) indicates a reasonable level of shareholder/employee compensation for the contractor's total officer group.

After subtracting the \$4,800,000 of total officer compensation (excluding the Smith compensation), the Exhibit 3 hypothetical independent investor test analysis presents a residual maximum reasonable shareholder/employee compensation for Smith. Based on the independent investor test summarized in Exhibit 3, the maximum reasonable shareholder/employee compensation available for Harry Smith is \$16,800,000.

Exhibit 2

Omega Construction Corporation

Reasonableness of Shareholder/Employee Compensation

Financial Ratio Analyses

Total Officers' Compensation as a Percent of Revenue

<i>Almanac of Business & Industrial Ratios [a]</i>			<i>RMA Annual Statement Studies [b]</i>			
Year	SIC Code	Mean Percent	Year	SIC Code	Median Percent	75th Percentile
2010	1541	18.7%	2010	1541	25.7%	34.0%

Range of Reasonable Compensation for All Officers as a Group

Total Officers' Compensation as a Percent of Revenue
 Multiplied by: Omega Construction Corporation 2010 Annual Revenue
 Equals: Reasonable Amount of Total Officers' Compensation

Industry Financial Ratio Observations

	18.7%	25.7%	34.0%
Total Officers' Compensation as a Percent of Revenue			
Multiplied by: Omega Construction Corporation 2010 Annual Revenue	<u>\$100,000,000</u>	<u>\$100,000,000</u>	<u>\$100,000,000</u>
Equals: Reasonable Amount of Total Officers' Compensation	\$18,700,000	\$25,700,000	\$34,000,000
Range of Maximum Reasonable Shareholder/Employee Compensation [c]	\$18,700,000	to	\$34,000,000
Less: Total Officer Compensation Paid to All Other Officers	<u>4,800,000</u>		<u>4,800,000</u>
Equals: Residual Range of Harry Smith Maximum Reasonable Shareholder/Employee Compensation	<u>\$13,900,000</u>	to	<u>\$29,200,000</u>

Notes:

[a] General contractors - industrial buildings and warehouses, asset size from \$50 to \$100 million.

[b] General contractors - industrial buildings and warehouses, asset size from \$50 to \$100 million.

[c] For all corporate officers of sponsor company Omega Construction Corporation.

The Simplified Illustrative Analysis Conclusion

In Exhibit 4, the three quantitative reasonableness of shareholder/employee compensation analyses in this example are summarized and the conclusions are presented. The valuation analyst will assess the reasonableness of the Harry Smith 2010 shareholder/employee compensation using these three quantitative analyses.

Based on the reasonableness of compensation analyses illustrated in Exhibits 1, 2, and 3 and summarized in Exhibit 4, the Harry Smith \$12 million shareholder/employee compensation that sponsor company Omega Construction Corporation paid in 2010 is reasonable.

Of course, this illustrative example and the corresponding analyses are deliberately simplified. Moreover, only the quantitative shareholder/employee reasonableness of compensation analyses are summarized. In an shareholder/executive actual reasonableness of compensation analysis, the valuation analyst would consider both the qualitative and quantitative Multi-Pak Corp. factors.

SUMMARY AND CONCLUSION

The reasonableness of the retained shareholder/executive compensation is often a disputed issue for the closely held ESOP sponsor company. This is par-

ticularly true when the retained shareholder/executive is the sponsor company controlling shareholder and the ESOP is a sponsor company noncontrolling shareholder.

This reasonableness of compensation issue may affect both valuation analyst and ESOP trustee considerations related to: ESOP formation feasibility, employer stock purchase fairness, employer stock valuation, sponsor company debt capacity, and ESOP (and other investor) investment exit planning. Accordingly, ESOP valuation analysts and other financial advisors often have to look to the federal income tax arena to find professional guidance related to this issue.

This discussion summarized the five shareholder/executive reasonableness of compensation factors considered in the *Multi-Pak Corp.* decision. In addition, this discussion presented a simplified example of the application of the quantitative reasonableness of compensation factors to a hypothetical ESOP sponsor company.

In the *Multi-Pak Corp.* decision, the Tax Court considered the *Elliotts, Inc.* five factors in rendering its decision on the reasonableness of shareholder/executive compensation. That judicial decision did not involve an ESOP sponsor company. However, the five factors discussed in that decision seem to be equally relevant to an ESOP employer corporation.

In the *Multi-Pak Corp.* case, the Tax Court concluded that a majority of the five factors prescribed

Exhibit 3

Omega Construction Corporation

Reasonableness of Shareholder/Employee Compensation

The Hypothetical Independent Investor Test

Fair Return on Equity Capital Analysis

	2006	2007	2008	2009	2010
	\$	\$	\$	\$	\$
Omega Construction Corporation					
Total Revenue	80,000,000	86,000,000	90,000,000	95,000,000	100,000,000
Total Expenses [a]	<u>42,000,000</u>	<u>50,000,000</u>	<u>52,500,000</u>	<u>57,000,000</u>	<u>64,000,000</u>
Pretax Income Before Officer Compensation	38,000,000	36,000,000	37,500,000	38,000,000	36,000,000
Fair Return on Equity Capital Analysis:					
Estimated Value of the Omega Total Owners' Equity Capital	95,000,000	96,000,000	10,000,000	110,000,000	120,000,000
Multiplied by: Pretax Fair Rate of Return on Owners' Equity Capital [b]					12%
Equals: Fair Return on Value of Total Owners' Equity Capital					<u>14,400,000</u>
Maximum Reasonable Total Officers' Compensation [c]					<u>21,600,000</u>
Less: Total Officer Compensation Paid to All Other Officers					<u>4,800,000</u>
Equals Residual Harry Smith Maximum Reasonable Shareholder/Employee Compensation					<u>\$16,800,000</u>

Notes:

- [a] Including all operating expense, interest expense, and ESOP contribution expense but before the officers' compensation expense.
- [b] For simplicity purposes only, this rate of return on equity only includes the current income yield (or the dividend yield) component of the total expected return on equity capital. The total expected
- [c] Pretax income before officer compensation for 2010 (\$36,000,000) less a fair return on the estimated value of total owners' equity capital (\$14,400,000) equals \$21,600,000.

an outcome favorable to the corporation. However, the Tax Court was compelled by its analysis of the independent investor test to decide against the corporation with respect to the amount of the compensation paid to the sole shareholder in 2003.

In its analysis of the independent investor test, the Tax Court concluded that a hypothetical independent investor would be willing to accept a reduced rate of return on equity in light of the "impressive sales growth" and stability of the subject business. In this instance, the Tax Court considered a 2.9 percent rate of return on equity to be acceptable to a hypothetical independent investor for 2002. However, the Tax Court concluded that the rate of return on equity of -15.8 percent in 2003 would not be acceptable to a hypothetical independent investor.

The ESOP-related guidance to be drawn from the *Multi-Pak Corp.* decision is that the independent investor test/return on equity analysis may sway the reasonableness of the closely held sponsor company shareholder/

executive compensation conclusion. The independent investor test may be the dominant reasonableness of retained shareholder/executive compensation factor, even when the predominance of the other five factors may call for a different compensation conclusion.

Notes:

1. *Multi-Pak Corp.*, T.C. Memo 2010-139.
2. 716 F.2d 1241 (9th Cir. 1983).
3. 178 F.2d 115 (6th Cir. 1949).
4. See Internal Revenue Manual section 4.35.2.5.2.2 (March 1, 2002 edition).

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Exhibit 4

Omega Construction Corporation

Harry Smith Reasonableness of Shareholder/Employee Compensation

Summary and Conclusion

Exhibit Reference	Reasonableness of Shareholder/Executive Compensation Analysis	Indicated Range of Harry Smith Maximum Reasonable Compensation
1	Salary Survey Analysis	\$8,850,000 to \$11,020,700
2	Financial Ratio Analysis	\$13,900,000 to \$29,200,000
3	Independent Investor Test	\$16,800,000
Harry Smith Total Employee Compensation Paid by Sponsor Company in 2010		\$12,000,000
Is the Harry Smith 2010 Shareholder/Employee Compensation Reasonable?		Yes