Reasonableness of Shareholder/Employee Compensation Guidance for Closely Held Corporations

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The Internal Revenue Service ("the Service") continues to challenge the tax deductibility of what it perceives to be excess compensation paid to closely held company shareholder/employees. The Service often alleges that these excess compensation amounts are disguised (and nondeductible) dividend payments. When these disputes reach the litigation stage, the courts often consider the so-called independent investor test to assess the reasonableness of closely held corporation shareholder/employee compensation. Essentially, the independent investor test determines whether the taxpayer company would earn a fair return on equity ("ROE")—after the recognition of the shareholder/employee compensation expense. Valuation analysts are particularly skilled at (1) measuring the taxpayer company ROE and (2) determining what should be considered a fair ROE for an investment in the taxpayer company. This discussion summarizes the professional guidance provided by the H.W. Johnson, Inc. v. Commissioner Tax Court *decision with regard to (1) the application of the independent investor test and (2) the assessment of the reasonableness of closely held corporation shareholder/employee compensation.*

Introduction

The Internal Revenue Service ("the Service") often challenges the reasonableness of the total amount of compensation that is paid to the shareholder/employees of closely held C corporations. The Service often claims that any alleged excess compensation amounts (particularly during the taxpayer corporation profitable years) are not tax deductible compensation payments at all. Rather, the Service often claims that such payments are disguised—and nondeductible—dividend payments.

Excess compensation amounts are typically measured as the amounts that the closely held corporation pays to the shareholder/employer in excess of what comparable employees would be paid to perform comparable work at comparable companies.

The United States Tax Court decision in *H.W. Johnson, Inc. v. Commissioner of Internal Revenue*[1] ("the *H.W. Johnson, Inc.*, decision"), provides recent guidance as to how the courts analyze this reasonableness of shareholder/employee compensation issue—particularly for closely held corporation taxpayers.

Although the *H.W. Johnson, Inc.*, decision is only a Tax Court memorandum decision, it is 32 pages in length. Accordingly, this published judicial decision does provide a fair amount of discussion regarding the court's rationale in this case.

In summary, the *H.W. Johnson, Inc.*, decision is very taxpayer friendly. As discussed below, the judicial decision was influenced by the testimony of competing forensic analyst ("analyst") testifying experts.

And, the forensic analyses of both litigant's forensic analysts—and the court's judicial decision—are heavily influenced by the specific facts and circumstances of this particular construction industry taxpayer.

In particular, the Tax Court was heavily influenced by the application of the so-called independent investor test to assess the reasonableness of the H.W. Johnson, Inc., shareholder/employee compensation.

The independent investor measures whether the taxpayer corporation earns a fair rate of return on equity ("ROE") after allowing for the expense of the shareholder/employee compensation. The fair rate of ROE is based on the level of ROE that an independent investor would consider to be acceptable for an investment in the subject taxpayer company.

Valuation analysts are particularly skilled at measuring a subject closely held company ROE. In addition, valuation analysts are particularly skilled at measuring a benchmark (or required level) ROE metric. The appropriateness of the selected benchmark ROE measure is often based on the degree of comparability of the subject company to the selected benchmark data sources.

The Tax Issues in the Dispute

H.W. Johnson, Inc. (a C corporation), was the taxpayer in this matter and the petitioner in the U.S. Tax Court case. The Service determined deficiencies in the taxpayer's federal income tax for the taxable years ended June 30, 2003 and 2004 ("the years at issue"), of $877,440 and $2,087,678, respectively.

The particular income tax issues that the Tax Court decided were as follows:

1. Whether the amounts paid to shareholder/employees Bruce A. Johnson and Donald J. Johnson during the years at issue were considered reasonable compensation and deductible under Internal Revenue Code Section 162
2. Whether the taxpayer was entitled to deduct a $500,000 payment made in 2004 to DBJ Enterprises, LLC, an entity controlled by Bruce and Donald, as an ordinary and necessary business expense under Section 162

Background on H.W. Johnson, Inc.

During the years at issue, H.W. Johnson, Inc., operated a concrete contracting business. At that time, the taxpayer company was one of the largest curb, gutter, and sidewalk contractors in the State of Arizona. The taxpayer company had over 200 employees, and it earned contract revenue of $23,754,182 and $38,022,612 in 2003 and 2004, respectively.

The taxpayer company was incorporated in 1974 by H.W. Johnson and his wife Margaret Johnson. H.W. and Margaret had operated a predecessor sole proprietorship out of their home since 1968.

Since the company founding, H.W. managed all of the company operations, and Margaret managed all of the company financial and administrative matters.

Two of the Johnson sons, Bruce and Donald, began working part time for the company as teenagers in the 1970s. The sons worked full time for the company after they completed their education in 1977 and 1982, respectively.

Bruce and Donald gradually assumed increasing management responsibilities at the company. And, they took over daily operations of the taxpayer company in 1993.

H.W. and Margaret made gifts of shares of the company stock to Bruce and Donald. By 1996, when H.W. retired from H.W. Johnson, Inc., Bruce and Donald each owned 24.5 percent of the shares, with Margaret retaining the remaining 51 percent of the shares.

Upon the retirement of H.W., the two brothers became co-vice presidents and members (along with Margaret) of the company board of directors.

The taxpayer company revenue increased rapidly after Bruce and Donald assumed control of the H.W. Johnson, Inc., operations in 1993. In 1993, the taxpayer company reported revenue of approximately $4 million. Company revenue increased to over $11 million and over $13 million in 1994 and 1995, respectively.

The taxpayer company revenue remained steady at about $17 million between 1996 and 1999 and increased consistently every year thereafter, including in the years at issue. In fact, the taxpayer company revenue increased dramatically between 2003 and 2004.

H.W. Johnson, Inc., was profitable and experienced significant revenue and asset growth during 2003 and 2004, with gross profit margins (before payment of officer bonuses) of 38.3 percent and 38.2 percent, respectively.

During 2002 through 2004, the H.W. Johnson, Inc., assets, liabilities, equity, revenue, net income before taxes, and net income after taxes were reported as presented in Exhibit 1.

During the years at issue, shareholder/employees Bruce and Donald personally guaranteed the company loans. The taxpayer company used those loan proceeds to purchase materials and supplies.

The Tax Years at Issue: 2003 and 2004

During the years at issue, Margaret served as the company president and chairman of the board. Margaret managed the company payroll and finances, accounts receivable and delinquent account collections, employee hiring and terminations, and various other administrative functions, working around 40 hours a week. Together Bruce and Donald managed all operational aspects of the company business.

The taxpayer company operations were split into two geographical divisions: eastern and western. Each brother managed one division's operations, including the following functions: contract bidding and negotiation, project scheduling and management, equipment purchase and modification, personnel management, and customer relations.

Bruce and Donald each supervised over 100 employees in their respective divisions, including superintendents and foremen. The two brothers each worked 10 to 12 hours a day, 5 to 6 days a week.

The two brothers were at the job sites daily, and they regularly operated equipment while there. The two brothers were readily available if problems occurred at a job site. And, Bruce and Donald were known in the local construction industry for their responsive and hands-on management style.

During the years at issue, approximately 95 percent of H.W. Johnson, Inc., business was related to residential subdivision construction. The concrete work supervised by Bruce and Donald required both considerable technical skill and coordination. This is because fresh concrete is highly perishable.

That is, concrete "sets"—and becomes unusable—either (1) 90 minutes after it is mixed and loaded onto a truck or (2) if it reaches a temperature of 90 degrees.

H.W. Johnson, Inc., had to meet the varying specifications of different contractors, engineers, cities, towns, and counties on any given job. The company operating equipment was often modified or specially fabricated to meet the requirements of a given job.

Most of that equipment modification work was performed in-house—thereby reducing costs and improving efficiency—with Bruce or Donald often supplying the idea for a design that was then refined and implemented by the company fabrication foreman.

H.W. Johnson, Inc., enjoyed an excellent reputation with developers, inspectors, and other contractors, and it was known for its timely performance and equality product. As a result, the taxpayer company was routinely awarded contracts even where it was not the lowest bidder. H.W. Johnson, Inc., needed little marketing beyond its reputation in the local construction market.

Exhibit 1
H.W. Johnson, Inc.
Results of Operations
Years 2002 through 2004

Financial Fundamentals	2002	2003	2004
Assets	$6,814,399	$8,844,769	$13,424,705
Liabilities	3,228,649	5,058,551	9,536,121
Equity	3,585,750	3,786,218	3,888,584
Contract Revenue	23,239,207	23,754,182	38,022,612
Net Income before Taxes	210,967	387,706	348,579
Net Income after Taxes	132,545	250,468	202,366

D.B.J. Enterprises, LLC

A reliable supply of concrete was necessary to the company operations. H.W. Johnson, Inc., did not produce its own concrete, instead relying on local suppliers. Starting in late 2002 and throughout the years at issue, there were shortages of concrete in the company's market due to a housing boom in Arizona. In addition, large multinational and national construction companies were acquiring suppliers of concrete in Arizona, disrupting the locally based network.

Faced with the possibility of disruptions in the company's supply of concrete, Bruce and Donald suggested to Margaret that H.W. Johnson, Inc., invested in a concrete supplier (in order to have a reliable supply). As the controlling shareholder, Margaret refused to involve the taxpayer company in such a venture—because she considered it to be too risky.

On March 21, 2003, Bruce and Donald, acting through D.B.J. Enterprises, LLC ("DBJ"), partnered with other investors (including a former executive of a local concrete supplier that had been acquired by a large multinational company) to form Arizona Materials, LLC ("Arizona Materials").

Arizona Materials was formed to conduct a concrete supply business. DBJ owned a 52 percent equity interest in Arizona Materials. Through DBJ, Bruce and Donald invested substantial sums in, and guaranteed the indebtedness of, Arizona Materials.

There were occasional market shortages of cement—an essential ingredient of concrete—during the years at issue. However, Arizona Materials was able to obtain access to cement during that period because of its relationship with other cement suppliers.

H.W. Johnson, Inc., obtained a substantial amount of its concrete from Arizona Materials during 2004. And, H.W. Johnson, Inc., was able to procure its concrete even when other contractors could not (and were, therefore, forced to temporarily suspend operations).

H.W. Johnson, Inc., received bulk discounts for large concrete purchases from Arizona Materials, obtaining concrete at a price lower than it paid to other suppliers. DBJ exercised its influence as majority shareholder of Arizona Materials to ensure that H.W. Johnson, Inc., received a steady supply of concrete. (At that time, Arizona Materials had other customers that were willing to pay a higher price for its concrete.)

The Shareholder/Employee Compensation Issue

At the end of 2004, H.W. Johnson, Inc., made a $500,000 payment to related party DBJ. The H.W. Johnson, Inc., board meeting minutes state that the payment was for a "guaranteed supply of concrete at market prices for the year ended June 30, 2004. DBJ has negotiated with Arizona Materials L.L.C. on behalf of H.W. Johnson, Inc. to provide a continuous supply of concrete."

The Service noted that H.W. Johnson, Inc., and DBJ had no written agreement regarding the $500,000 payment.

During the years at issue, the H.W. Johnson, Inc., board held annual meetings in May to determine officer compensation, director's fees, and dividends. For those years, the taxpayer company compensated Bruce and Donald as presented in Exhibit 2.

The H.W. Johnson, Inc., officer bonus formula was adopted by the company board in 1991, and it was later amended in 1999. The total potential bonuses were calculated in proportion to the company's annual contract revenue, and the amounts were added to a "bonus pool."

At year end and upon the advice of the company accountant, the board of directors issued bonuses out of the bonus pool based on:

1. officer performance and
2. the company's ability to pay.

Any unpaid amounts remained in the company bonus pool for later payment, pending the board approval.

During the years at issue, H.W. Johnson, Inc., had a dividend plan, adopted in 1991 and later amended in 1999. That plan called for dividend payments when the company retained earnings balance exceeded $2 million. The company board determined the amount of the dividend on the basis of the company financial position, profitability, and capitalization, following the advice of the company accountant.

H.W. Johnson, Inc. paid modest dividends to its shareholders between 1996 and 2004. For most of those years, the dividend amount was $25,000. In 2002 and 2003, the dividend amount increased

Exhibit 2
H.W. Johnson, Inc.
Shareholder/Employee Total Compensation
For the Years 2003 and 2004

Company Officer	2003	2004
Bruce	$2,013,250	$3,651,177
Donald	2,011,789	3,649,739
Total	4,025,039	7,300,916

to $50,000. In 2004, the dividend amount was $100,000.

The Audit and the Tax Deficiency

On a timely filed Form 1120, U.S. Corporation Income Tax Return, for 2003 and 2004, H.W. Johnson, Inc., claimed income tax deductions for the salaries, bonuses, and director fees paid to Margaret, Bruce, and Donald.

The taxpayer company also claimed a deduction for 2004 for the $500,000 amount that it paid to DBJ, reporting the payment as an "administration fees" expense.

The Service issued a notice of deficiency to H.W. Johnson, Inc., determining that $2,607,517 and $5,616,771 of the amounts the company deducted for 2003 and 2004, respectively, as officer compensation exceeded so-called reasonable compensation.

The Service also disallowed in its entirety the $500,000 deduction that the taxpayer company claimed for 2004 as administration fees.

The Tax Court Analysis

At trial, the Service concluded that deductions of $3,214,000 and $6,532,000 for shareholder/employee compensation were reasonable, leaving $811,039 and $768,916 as the excess compensation amounts in dispute for 2003 and 2004, respectively.

The Tax Court noted that Section 162(a)(1) allows a taxpayer to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered" as an ordinary and necessary business expense. The taxpayer is entitled to a deduction for compensation payments if the payments:

1. are reasonable in amount and
2. are paid purely for services.

Though framed as a two-pronged test, courts considering the deductibility of shareholder/employee compensation under Section 162(a)(1) typically focus only on whether the compensation amount is reasonable.

In the *H.W. Johnson, Inc.*, case, the taxpayer had the burden of proving that the amounts paid to shareholder/employees Bruce and Donald in 2003 and 2004 were reasonable.

The Tax Court noted that the Court of Appeals for the Ninth Circuit (to which an appeal of this decision would be made) applies the following five factors to determine the reasonableness of compensation, with no one factor being determinative:

1. The employee's role in the company
2. A comparison of compensation paid by similar companies for similar services
3. The character and condition of the company
4. Potential conflicts of interest
5. The internal consistency of compensation arrangements

These are the so-called "five factors" described in the *Elliotts v. Commissioner* decision.[3]

In analyzing the fourth factor, the Court of Appeals emphasized evaluating the reasonableness of shareholder/employee compensation payments from the perspective of a hypothetical independent investor. That is, this fourth factor focuses on whether the independent investor would receive a reasonable return on equity after payment of the shareholder/employee compensation.

This so-called "independent investor test" is described both in the *Elliotts* decision and in the *Metro Leasing Dev. Corp. v. Commissioner* decision.[4]

At trial, both parties introduced expert witness reports and analyst testimony to support their respective positions.

The Service effectively conceded four of the five *Elliotts* factors that tended to support, or were at least neutral with respect to, the reasonableness of the shareholder/employee compensation paid by H.W. Johnson, Inc.

Nonetheless, the Service argued that the subject case hinged on the fourth *Elliotts* factor: namely, whether a hypothetical independent investor would receive an adequate ROE after accounting for the amount of shareholder/employee compensation paid to Bruce and Donald.

Accordingly, the Tax Court considered each of the *Elliotts* factors. However, the Tax Court focused on the independent investor test factor.

The Independent Investor Test

The Tax Court noted that the Ninth Circuit approached the fourth *Elliotts* factor by evaluating the compensation payments from the perspective of a hypothetical independent investor, focusing on the investor's rate of ROE.

If the subject company ROE (after payment of the shareholder/employee compensation) remains at a level that would satisfy an independent investor, there is strong evidence that:

1, the shareholder/employee is providing compensable services and

2. company profit-related dividends are not being disguised as salary.

In the subject case, both expert analysts agreed that H.W. Johnson, Inc., earned a pre-tax ROE of 10.2 percent and 9 percent for 2003 and 2004, respectively. The analysts differed, however, on what a required rate of ROE should be for the taxpayer company.

The Service's analyst used ROE data from four financial report empirical data sources. These four sources indicated an ROE ranging from 13.8 percent to 18.3 percent. The Tax Court concluded that the industry data on which the Service analyst relied were not as reliable as the industry data used by the company's analyst.

The Service analyst's first ROE indication was derived from seven selected "guideline companies." The Tax Court concluded that the selected guideline companies were not sufficiently comparable to H.W. Johnson, Inc. This was because "they were publicly traded, operated in industries different from petitioner's, and had gross sales substantially larger than petitioner's."

The Service analyst's second ROE indication was derived from industry data in an annual statement published by the Risk Management Association. The Tax Court noted that the publication itself states that its data should be used "only as general guidelines and not as absolute industry norms."

This is because the data "may not be fully representative of a given industry" for several reasons, including that:

1. the data are not randomly selected and
2. the data may include small sample sizes for certain industries.

The Service analyst's third ROE indication was derived from the Construction Financial Management Association annual financial survey. The Tax Court noted that "many of the companies in that data sample operated in industries dissimilar from petitioner's."

Finally, the Service analyst derived a "market required return on equity" from data published by Ibbotson Associates. The Tax Court was concerned because "that data is from companies engaged in the construction industry generally, not the concrete contracting sector of which petitioner is a part."

The taxpayer's analyst used ROE indications derived from Integra Information ("Integra") data. Integra is a data service that compiles financial information of privately held companies from government and other sources. The company's analyst used Integra data from 33 companies in SIC code 1771, construction—special trade contractors—concrete work, with revenue ranging from $25 million to $49,999,999.

The Tax Court noted: "We find the companies that petitioner's expert used to be more comparable to petitioner for purposes of a return on equity analysis than those used by respondent's expert."

The taxpayer's analyst calculated an average pretax ROE from these 33 companies of 10.5 percent and 10.9 percent for calendar years 2003 and 2004, respectively. Accordingly, the actual H.W. Johnson, Inc., pretax ROE was 0.3 percentage points less than the Integra companies' average ROE in 2003 and 1.9 percentage points less than the Integra companies' average ROE in 2004.

Of course, the parties disagreed about whether H.W. Johnson, Inc., had, in fact, "passed" the independent investor test—even based on the taxpayer analyst's ROE conclusions.

At trial, the Service argued that, because the taxpayer company ROE was slightly below the industry average ROE in 2003 and 2004, Bruce and Donald were unreasonably compensated in those years. An independent investor would have required a ROE that was more commensurate with the company's superior performance, the Service claimed.

The company maintained that its actual ROE was generally in line with the industry average and, therefore, H.W. Johnson, Inc., had satisfied the independent investor test.

The Tax Court concluded: "We agree with petitioner." The Service produced no authority for its position that the required rate of ROE for purposes of the independent investor test must significantly exceed the industry average ROE, particularly when the taxpayer company has been financially successful.

The Tax Court's decision stated: "We consequently find that petitioner's returns on equity of 10.2 percent and 9 percent for 2003 and 2004, respectively, tend to show that the compensation paid to Donald and Bruce for those years was reasonable. As petitioner's expert points out, mere reductions in their collective compensation of $9,847 and $75,277 in 2003 and 2004, respectively—differences of approximately 1 percent—would have placed petitioner's return on equity at exactly the average for comparable companies in the concrete business. Consequently, this factor favors a finding that the compensation at issue was reasonable."

In summary, the *Elliotts* factors—particularly the independent investor test—supported the conclusion that the compensation the construction company paid to Bruce and Donald in 2003 and 2004 was reasonable. The two brothers were integral to the company's successful financial performance, a performance that included growth in revenue, assets, and gross profit margins during the disputed years.

Therefore, the Tax Court concluded: "The return on equity petitioner generated for each year after payment of Bruce's and Donald's compensation was in line with—indeed closely approximately—the return generated by the companies most comparable to it. We accordingly conclude that an independent investor would have been satisfied with the return. For these reasons, we hold that the $4,025,039 and $7,300,916 petitioner paid as officer compensation in 2003 and 2004, respectively, were reasonable and therefore deductible under Section 162(a)(1)."

The DBJ Payment

In addition, the Tax Court had to decide whether taxpayer H.W. Johnson, Inc., could deduct the $500,000 "administration fees" expense paid to DBJ and reported on its 2004 tax return as a business expense.

The taxpayer company argued that the $500,000 "administration fees" expense was an ordinary and necessary business expense. The company argued that the payment was made to DBJ for securing a guaranteed supply of concrete, discounted for bulk purchases, from Arizona Materials during 2004.

In contrast, the Service argued that the $500,000 payment was not an ordinary and necessary business expense and:

1. there was no written agreement or evidence of any oral agreement obligating petitioner to compensate DBJ, and, therefore, the $500,000 payment was voluntary;
2. DBJ performed no compensable services on behalf of petitioner; and
3. the $500,000 payment was made not for services that DBJ provided, but for services Bruce and Donald performed in their capacities as officers of H.W. Johnson, Inc.

The Tax Court concluded: "Respondent's arguments are unpersuasive."

The Tax Court noted that Bruce and Donald, acting through DBJ, used the DBJ controlling ownership position in Arizona Materials to cause Arizona Materials to supply concrete to H.W. Johnson, Inc., during times of shortage at favorable prices.

Bruce and Donald, acting in their individual capacities, when their more risk-adverse, controlling shareholder mother would not allow H.W. Johnson, Inc., to do so, made arrangements to form Arizona Materials to ensure the H.W. Johnson, Inc., concrete supply in the face of looming shortages.

The two brothers, again acting in their individual capacities and using DBJ as a vehicle, invested substantially in—and guaranteed the indebtedness of—Arizona Materials. The brothers assumed the risk associated with the Arizona Materials formation and operation in their individual capacities.

Therefore, the Tax Court concluded that Bruce and Donald could reasonably expect to be compensated by H.W. Johnson, Inc., for doing so when it substantially benefitted from the fruits of their efforts.

The Tax Court noted: "In view of the foregoing, respondent's contention that petitioner's payment to DBJ was voluntary, given the absence of a written agreement or evidence of an oral agreement to compensate DBJ, is unavailing."

And, the Tax Court concluded: "We are satisfied that petitioner's board, including majority shareholder Margaret, concluded at the close of 2004 that the $500,000 payment to DBJ was appropriate to compensate Bruce and Donald for the substantial benefit they conferred on petitioner in their individual capacities."

The Tax Court decision states: "In the same vein, we do not agree with respondent that DBJ provided no compensable services to petitioner."

In summary with regard to the related party payment, the Tax Court concluded: "The $500,000 payment petitioner made in consideration of the resulting benefits was therefore earned and received by Bruce and Donald (through DBJ) in their individual capacities."

The Tax Court ruled that the $500,000 payment was an ordinary and necessary expense within the meaning of Section 162(a). This was because it was normal for a concrete contractor to expend funds in connection with ensuring a reliable supply of concrete in the face of shortages.

In addition, the expenditure was helpful to the H.W. Johnson, Inc., business, allowing it to meet customer demand when other contractors were hampered by the concrete shortage.

Summary and Conclusion

The *H.W. Johnson, Inc.*, decision is a taxpayer friendly judicial decision with regard to the reasonableness of closely held corporation shareholder/employee compensation. Of course, the specific facts and circumstances of the case were very favorable to the taxpayer's position.

First, the Tax Court relied on the *Elliott's* five factors in its reasonableness of shareholder/employee compensation analysis. In particular, the Tax Court relied heavily on the so-called independent investor test to assess the reasonableness of the closely held corporation's shareholder/employee compensation. The independent investor test is based on the reasonableness of the subject company's rate of ROE.

Second, both the Service analyst and the taxpayer analyst applied the independent investor test. The Tax Court seemed to be most influenced by the comparability of (or the lack of comparability of) the benchmark industry empirical data used by both analysts to calculate to required rate of ROE measurement.

Third, the Tax Court concluded that the taxpayer company did not have to exactly achieve the industry average rate of ROE. For a financially successful taxpayer company (like H.W. Johnson, Inc.), achieving a ROE sufficiently close to the industry average ROE calculation was sufficient to "pass" the independent investor test.

Fourth, the Tax Court was impressed with the measurable economic benefit to H.W. Johnson, Inc., associated with the DBJ relationship. Accordingly, the specific facts and circumstances of the case convinced the Tax Court of the tax deductibility of the DBJ payment.

"[V]aluation analysts are uniquely qualified (1) to measure the closely held company rate of ROE and (2) to calculate an empirically based benchmark level of an independent investor required rate of ROE."

For closely held taxpayer corporations, the documentation of the actual facts and circumstances help the taxpayer win the day with regard to the tax deductibility of (1) shareholder/employee compensation and (2) related party payments.

The Service continues to challenge what it perceives to be unreasonable shareholder/employee compensation or unsupportable related-party payments.

The closely held company taxpayer (and the taxpayer's legal counsel and forensic analyst) can prevail in a judicial challenge based on having the superior factual documentation and the superior empirical analysis.

Particularly with regard to the implementation of the independent investor test, valuation analysts are uniquely qualified (1) to measure the closely held company rate of ROE and (2) to calculate an empirically based benchmark level of an independent investor required rate of ROE.

Notes:

1. H.W. Johnson, Inc. v. Commissioner of Internal Revenue, T.C. Memo 2016-95 (May 11, 2016).
2. See Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1244 (9th Cir. 1983), *rev'g* T.C. Memo. 1980-282.
3. Elliotts v. Commissioner, 716 F.2d at 1245-1247.
4. Metro Leasing Dev. Corp. v. Commissioner, 376 F.3d 1015, 1019 (9th Cir. 2004), *aff'g* T.C. Memo. 2001-119.

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