

T&E - Alert July 28, 2010

Multi-Pak Corporation v. Commissioner of Internal Revenue, U.S. Tax Court, TC Memo. 2010-139 filed June 22, 2010

This decision is a must-read for all concerned about reasonable compensation of closely-held company management, particularly when manager[s] and shareholder[s] are the same. The decision, in a fairly common fact pattern, returned a victory for the tax payer. The decision is not breaking ground, but is well supported.

IRC 162 (a) (1) allows the deductibility of ordinary and necessary expenses, including a reasonable allowance for salaries or other compensation for personal services actually rendered. The U.S. Court of Appeals for the 9th Circuit decided Elliotts, Inc. in 1983, and Estate of Mitchell, Morrissey, and Estate of Simplot in 2001, the 2001 decisions focusing on burden of proof issues. The Elliotts analysis uses the following 5 determining factors:

- The employee's role in the company;
- Comparison with other companies;
- The character and condition of the company;
- Potential conflicts of interest; and
- Internal consistency in compensation.

Multi-Pak is a California based pills and capsules packaging business which its sole shareholder turned around financially and operationally by attracting a major new customer, by redesigning, rebuilding and expanding its equipment and capabilities, while insuring compliance with FDA regulations. He managed the entire operation "hands-on," performing both inside and outside functions. It is clear that the strong top and bottom lines performance was due to the president's efforts. In the 2002 and 2003 years at issue, he paid himself annual compensation of over \$2 million or between 21.3% and 23.6% of revenues. Except in 2003, when a loss was incurred due to a modest decrease in sales, the Company was quite profitable, did not use debt and could expect continued profitability and growth.

The Court applied the Elliotts factors and concluded they argued in favor of the tax payer, except for the second factor as the evidence provided by experts was inconclusive. It is indeed difficult to find compensation data for private companies, and public companies are generally larger than Multi-Pak and thus not comparable. The returns on stockholder's equity were deemed by the Court as generally acceptable from an "hypothetical independent investor" perspective. In the end, the Court ratified the compensation deducted by the corporation in 2002, but shaved the 2003 compensation to \$1.2 million, a 37.6% decrease which would have provided the shareholder with a 10% return for that year. Due to the company's reliance on its accountant's calculation, the Court found penalties under IRC 6662[a] were not applicable.

The decision can be found on the U.S. Tax Court's website and at <http://www.NYNJCT-BV.com/MultiPak.TCM.WPD.pdf> Please do not hesitate to call or e-mail to discuss this or any valuation issue.

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