



WHEN RESULTS COUNT

TAX VALUATION E-FLASH

Special Edition

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Dexsil Corporation v. Commissioner, T.C. Memo. 1999-155, May 5, 1999

This case is a remand from the Court of Appeals for the Second Circuit in *Dexsil Corp. v. Commissioner*, 147 F.3d 96 (2d Cir. 1998), vacating and remanding T.C. Memo 1995-135. The Second Circuit ordered the Tax Court to make specific findings regarding the following questions:

1. Whether a hypothetical investor would accept the compensation paid to [Theodore R.] Lynn;
2. Whether Lynn was paid according to a long-standing and consistently applied contingent compensation formula, and if so, whether his salary was reasonable in light of this formula;
3. Whether Lynn's compensation compared favorably with the compensation paid by similar companies for comparable services, given the many roles Lynn played at Dexsil; and
4. whether, after reconsideration of these factors, the balance of factors has shifted in favor of Dexsil such that it has met its burden of proving that Lynn's compensation was reasonable.

In the Tax Court's original opinion, the Court concluded that \$300,000 and \$320,000 for the fiscal years 1989 and 1990, respectively, was reasonable compensation for Theodore R. Lynn (Lynn), the majority shareholder, president, and a director of the Company. The Court disallowed the Company's deductions, to the extent of \$76,540 in 1989 and \$168,000 in 1990. The Court agreed with the Company that the amount paid to Lynn's son, Timothy D. Lynn (T.D. Lynn), a shareholder, vice president, and director, was reasonable, but disallowed in part a deduction claimed for compensation to another son, Theodore B. Lynn (T.B. Lynn), and a deduction for director's fees.

1. Hypothetical or Willing Investor Test

The only evidence at trial relating to the rate of return acceptable to a hypothetical investor was the taxpayer expert's compilation of data on New York Stock Exchange companies. There was no evidence presented, however,

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that those companies were comparable to the taxpayer or that the average return of those companies would be satisfactory to a hypothetical investor in a company with the degree of risk associated with the taxpayer's business.

On remand, the taxpayer tried to compare the rate of return in this case to other cases in which the reasonableness of compensation paid to shareholder-officers of closely held companies was determined. The Tax Court did not accept that approach, noting that each case must be decided on the evidence in that case and on the specific characteristics of the company and the employee involved. According to the Tax Court,

The deficiencies in the expert evidence in this case cannot be overcome by surveys of results in different cases decided on different evidence. Petitioner's proposed method of surveying cases suggests that we decide the issue as "what the traffic will bear", excluding consideration of all nonlitigated compensation arrangements and other relevant market data.

The Court concluded that a hypothetical independent investor would not accept the compensation as reasonable.

2. Contingent Compensation Formula

The taxpayer claimed a bonus formula existed, but the Tax Court noted that there was no testimony indicating when and how the formula was established. The testimony that was given was termed "vague" and "retrospective." The Tax Court was not persuaded that the formula existed or was consistently applied.

3. Comparison with Compensation Paid by Similar Companies

The taxpayer tried to add together the salaries for the Chief Executive Officer and the Chief Financial Officer for a comparable company and claim that based on Lynn's duties, he should be compared to the combined total. The Tax Court did not accept this argument.

4. Burden of Proof

On remand the taxpayer relied on the formula for the bo-

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nus as meeting their burden of proof. Since the Tax Court did not believe the formula existed, the burden of proof argument also failed.

The Tax Court reached a decision that matched their original determination and said:

As we indicated in our prior memorandum opinion, the data compiled by respondent's expert showed that Lynn's compensation was more than four times the median CEO compensation for seven comparable companies during the years in issue. There was no evidence that Lynn's compensation for the years in issue was intended to compensate him for any past undercompensation. Petitioner's return on equity was declining during the years in issue, and the dividends paid were negligible in comparison to increased sales. We do not believe that the hypothetical independent investor, under these circumstances, would have approved hikes in

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