WHEN RESULTS COUNT

TAX VALUATION E-FLASH

Special Edition

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Wagner Construction, Inc. v. Commissioner, T.C. Memo 2001-160 (June 29, 2001)

This case relates to the compensation paid by Wagner Construction, Inc. to brothers Dennis and Curtis Wagner. The following table illustrates the compensation amounts at issue. (The amounts listed for the IRS are those argued on brief, which are more than double the amounts allowed by the IRS in its original notice of deficiency.)

Taxpayer			
Year	Dennis	Curtis	Total
10/31/1995	$ 1,048,200	$246,688	$ 1,294,888
10/31/1996	699,192	400,573	1,099,765
Internal Revenue Service			
Year	Dennis	Curtis	Total
10/31/1995	$ 243,000	$192,450	$ 435,450
10/31/1996	258,600	202,350	460,950
Tax Court			
Year	Dennis	Curtis	Total
10/31/1995	$ 385,000	$250,000	$ 635,000
10/31/1996	385,000	250,000	635,000

The Tax Court rebuked the experts on both sides of the case, saying,

> *Because of fundamental differences in approach among the experts engaged by both parties, the values arrived at in the reports are extremely far apart. Although it is not unusual in valuation cases that two experts reach significantly different conclusions, the reports and testimony of the experts in this case are so dissimilar that the reliability of the experts is brought into question. In this case, the experts reached conclusions that patently favored their respective clients, and their reports were designed to*

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Value measurement is used for many purposes, including:

- Business Planning
- Succession Planning
- Purchase Price Allocations
- ESOP Values
- Economic Damages
- Corporate Dissolutions
- Shareholder/Partner Disputes
- Marital Dissolutions
- Estate and Gift

support their conclusions.

The purpose of expert testimony is to assist the trier of fact to understand evidence that will determine the fact in issue . . . That purpose is jeopardized when an expert assumes the position of an advocate. An expert has a duty to the Court that exceeds his duty to his client; the expert is obligated to present data, analysis, and opinion with detached neutrality and without bias, regardless of the effect of such unbiased presentation on his client's case. When an expert displays an unyielding allegiance to the party who is paying his or her bill, we generally will disregard that testimony as untrustworthy... (when experts act as advocates, "the experts can be viewed only as hired guns of the side that retained them, and this not only disparages their professional status but precludes their assistance to the Court in reaching a proper and reasonably accurate conclusion"). The experts' lack of impartiality has caused a disservice to the Court and the system of tax administration. [Citations omitted]

The taxpayer's expert researched the proxy statements of public companies, but found no comparable companies for compensation purposes. The expert then compared the taxpayer's compensation to various published compensation studies. Because of the duties of the taxpayer's two officers and their long work hours, and the size of the management teams for the companies in the studies, the expert determined it would take four people to replace Dennis. The Tax Court, however was critical of the assumption that Dennis' salary should be equal to that of four executives. The Court also found portions of the studies to be unreliable.

The taxpayer expert's next approach was to calculate the taxpayer's "residual economic income after a fair return on the total fair market value of the stockholders' invested capital." The analysis included a period a time

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during which this expert claimed the officers were undercompensated. The Tax Court said, "An executive has not been undercompensated simply because the stockholders received an excellent return that greatly exceeds a 'fair' return." The Court termed the use of a 10-year period for analysis "merely an attempt to justify payments in excess of the amount [the expert] could compute using his other methods."

The first IRS expert used publicly traded companies finding 12 comparable companies. The Court found that this analysis had a "fatal flaw" saying, "none of the 12 publicly traded companies he selected was reasonably comparable to petitioner. All of them were much larger than petitioner, particularly in terms of their respective annual sales." This expert also failed to account for stock options in the public companies and the Tax Court rejected this expert's opinion.

The second IRS expert used published studies to determine reasonable compensation. The Court rejected this expert's opinion saying, "We find the report of [the expert] to be unreliable. The report contains several typographical and mathematical errors." This expert also failed to take into account the stock options granted by public companies.

The Tax Court then engaged in its own analysis of compensation reasonableness using nine factors that were used by the Court of Appeals for the Eighth Circuit, to whom this case could be appealed. These factors are:

1. The employee's qualifications;
2. The nature, extent, and scope of the employee's work;
3. The size and complexities of the business;
4. The prevailing general economic conditions;
5. The prevailing rates of compensation for comparable positions in comparable concerns;
6. The salary policy of the taxpayer as to all employees;
7. In the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years;

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8. A comparison of salaries paid with the gross income and the net income; and
9. Comparison of salaries with distributions to stockholders.

The Court concluded that an independent investor would not approve salaries in excess of $635,000 unless the investor was receiving a fair return on investment. Using the return on investment percent determined by the taxpayer expert, the Court calculated that salaries in excess of the $635,000 represented disguised dividends.

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