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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

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DEALER TAX WATCH *OUT*

If you had called me personally to ask, "What's happening lately with IRS audits of dealers and dealerships that I need to know about?"... Here's what I'd say:

#1. *METRO LEASING*... A REALLY GOOD CASE STUDY FOR ADVISORS TO DEALERS & DEALERSHIPS. Last year, hundreds of tax cases were decided by the courts and some were far more important than others. Mid-year, one Tax Court Memo decision that came floating in along with the tide was *Metro Leasing & Development Corporation* (T.C. Memo 2001-119).

Tax Court decisions are accorded lesser *Memorandum* status typically because they do not involve major interpretations of the tax law. These cases usually resolve issues arising over the different interpretations that the taxpayers and the IRS have over just what are the facts and how the law should be applied to these facts.

Metro Leasing attracted our attention as a case that presents an excellent opportunity to take advantage of the mishaps or misadventures that befell one taxpayer in a situation that could be very typical of many dealer situations that *DTW* readers are likely to encounter.

As you can tell from the table of contents, Metro got itself into trouble with the IRS over reasonable compensation, unreasonable accumulation of earnings and accuracy-related penalties.

In the Tax Court, Metro received what might be described as a "split-decision." The Tax Court allowed a little bit more than the IRS would have in the way of compensation for 1995 and 1996. The Tax Court sided with the IRS on the unreasonable accumulation of earnings for 1995 and the 39.6% penalty tax under Section 531 was assessed. However, the Court declined to impose any accuracy-related penalties on Metro for either year.

Metro Leasing made another appearance in the Tax Court this year (119 T.C. No. 2, filed July 17, 2002) because it did not agree with how the IRS computed the penalty tax under Section 531. This case is of more limited interest to auto dealership advisors because it only involved technical interpretations of the Regulations under Section 533.

Metro Leasing should be closely studied for its reasonable compensation, accumulated earnings tax and accuracy-related penalty tax issues. More broadly and importantly, you can use this case like a roadmap to plan a long journey with C corporation dealers that are in transition, and who are likely to be selling their operating assets soon. This case is also instructive if the dealer owns a C corp. which, in turn, owns and leases dealership facilities and collects rent on them. Potential application also includes Pontiac dealerships

WATCHING OUT FOR

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presently negotiating their "transitions" with General Motors.

Accordingly, we have devoted almost this entire issue of the *DTW* to *Metro Leasing* and what we think you can learn from it that will be helpful to you in your practice. After you've read our coverage which begins on page 6, tell us if there's anything you'd like to add to our list of "Planning Lessons Inspired by *Metro Leasing*" which appears on page 13.

#2. MORE ON THE TAX RELIEF AFFORDED BY THE 9-11 LEGISLATION LAST YEAR. Last issue, we called attention to the possibility that you might be filing amended returns as a result of the changes in the law added after last September 11. These changes included (1) extending the carryback period for net operating losses and (2) increasing the depreciation deduction for certain eligible property to 30% in the first year. See the March 2002 *DTW* Update #5 and pages 4-5 for these details.

We pointed out some questions that were likely to arise in working through all of the details. Now these questions and other aspects of both provisions are covered in Revenue Procedure 2002-33 ... for the 30% bonus depreciation eligibility and computation rules ... and in Revenue Procedure 2002-40 ... dealing with the switch to a 5-year net operating loss carryback that is available until October 31 of this year.

One important aspect of these changes to consider is that some states go along with all Federal changes. These are the so-called "conforming" states. Unfortunately, many other states do not automatically allow Federal changes to be incorporated into their own income tax base computations for state purposes. As states become more pressed for revenues, they obviously become more inclined to be "nonconforming" states. You'll need to check this carefully with either the web site that each state's Department of Revenue maintains or with some other reliable source.

Finally, be aware of the possibility that a state may be "conforming" as far as the 30% first-year depreciation changes are concerned, but it may be "nonconforming" (or decoupled from the Federal rules) as far as the extension of the carryback period to 5 years for NOLs is concerned... Or vice-versa!

#3. OLDS DEALERS IN TRANSITION. We always appreciate feedback and input from our readers. Here's one very valuable insight from a very reliable source (and we've seen the paperwork) for those of you consulting with Olds dealers in connection with the General Motors phase-out.

If an Olds dealer demonstrates/proves that he's really serious about getting a better "deal" from GM by filing a lawsuit, GM will take notice and negotiate far beyond the initial offerings it made in pre-litigation discussions.

In other words, if a dealer is willing to go to the extent of suing GM ... and is willing to share some of the spoils with the attorneys ... that dealer is likely to come out much further ahead than if he simply tried to wing it on his own.

#4. A TRIPLE BIG WINNER ... ACCOUNTING METHOD CHANGES & COST SEGREGATION STUDIES FOR DEALERSHIP FACILITIES. In the March 2002 issue (Update #10), we mentioned the updated Revenue Procedures that the IRS recently issued in connection with automatic and other changes in accounting methods.

In Revenue Procedure 2002-9 the IRS increased the number of accounting method changes that taxpayers can make as "automatic" changes without first securing permission from the IRS. Changes in depreciation methods fall into the "automatic" change category. The IRS has further updated Rev. Proc. 2002-9 and ***one of these changes now gives taxpayers a big break.***

If depreciation accounting method changes are combined with another planning strategy employed by many dealers ... cost segregation studies that end up with huge accelerated depreciation deductions ... the results can be astounding.

And, it all gets even better because the depreciation classification changes that often result from cost segregation studies can ***now*** be linked to the increased first-year 30% depreciation provisions that are part of the 9-11 relief legislation!

Here's the general picture. In Rev. Proc. 2002-19, the IRS indicated that it will now allow taxpayers to deduct the entire amount of any favorable Section 481(a) adjustment in one year. Previously, Rev. Proc. 2002-9 had required that any negative Section 481(a) adjustments, i.e., taxpayer-favorable adjustments reducing taxable income, would have to be taken into income over four (4) years.

As a result of the change made by Rev. Proc. 2002-19, current automatic accounting method changes with negative Section 481(a) adjustments now result in the entire deduction being taken into account in one year. This is far more beneficial to taxpayers than the original 4-year spread treatment.

For more on the advantages of cost segregation studies for dealerships, see "Cost Segregation Studies Maximize Depreciation Opportunities," in the Sep-

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tember 2000 *Dealer Tax Watch*. If the results of previous cost segregation studies appeared to be marginal, with these ***two*** new developments, they may now be even more attractive.

Concerning cost segregation studies, it was reported by one source that the Treasury Department in its Year 2000 report indicated that many taxpayers are able to take an aggressive position on depreciation after conducting these surveys, in part because of the resource constraints on the part of the IRS to monitor and evaluate the appropriateness of Section 1245 designations.

It was further reported that the IRS has said ... "The sheer volume of individual items is staggering and the IRS may not be able to review adequately each cost segregation study." For an excellent write-up on this, see "Cost Segregation Studies Are More Lucrative with 30% Bonus Depreciation," *Accounting Today*: July 22-August 4, 2002, pages 10-12.

#5. MORE ON BHPH DEALERS & THEIR "DRIVE" TO USE THE CASH METHOD ... READER'S RESPONSE. We appreciate and pass along for your consideration one reader's response to our coverage and comments on this issue. (See "IRS Ponders Allowing BHPH Dealers to Use the Cash Method," March 2002 *DTW*, page 6.)

Ken Shilson, a CPA in Houston, is also President of the National Association of Buy-Here, Pay-Here Dealers. In a recent letter, he pointed out that our coverage was silent on the very significant problem regarding cash equivalents. He added that "A review of the NIADA comment letter also did not address this problem. Based on conversations with the IRS, it appears that even if BHPH dealers could use the cash method as proposed by NIADA, they still would not benefit as I explain."

Ken was kind enough to allow us to reprint NABD's recent letter discussing this problem that was sent on behalf of used car dealers to Terri Harris, the IRS Motor Vehicle Technical Advisor. (See pages 4-5.)

#6. TECHNICIAN TOOL RENTAL & REIMBURSEMENT PROGRAMS. If you've been keeping a file on this subject for your dealer clients, you might want to include in it two recent Revenue Procedures, 2002-35 and 2002-41. These do not specifically relate to auto dealers, but they provide more background on the subjects of accountable plans and optional expense substantiation rules in connection with their use by other industries.

Rev. Proc. 2002-41 is particularly interesting because of the question-and-answer approach that it takes to this subject ... much like that used by the IRS in Rev. Proc. 2001-56 late last year in coming out with its new demo use rules.

#7. EXPECT MORE IRS ACTIVITY? OR DOES THE IRS ALREADY HAVE MORE ON ITS PLATE THAN IT CAN HANDLE? Not only has the IRS announced its intention to pursue a quasi-TCMP-like audit process (Update #9, March 2002 *DTW*), it has now added that it will be moving ahead with even more audits at the urging of Congress. It seems that Congress really got upset when it found out that the IRS wasn't planning (or was it *able*?) to audit partnership returns until at least 2005.

Not to be cynical about things ... but did you happen to read the article in the June 20, 2002 *New York Times* entitled "Big Accounting Firm's Tax Plans Help the Wealthy Conceal Income"?

These peddlers, also known as *consultants*, of so-so-sophisticated tax shelter schemes are further tarnishing the once-respectable – almost invincible – image of integrity our profession once enjoyed. It's sad, especially for newcomers into the profession who will have to deal with this fallout for many years to come.

After reading this expose in the *Times*, one can't help but wonder if the efforts of "smaller" CPA-type practitioners and firms (like many of our *DTW* readers) to keep clients out of trouble with the IRS ... or at least to keep them away from more aggressive/egregious schemes ... are hardly worthwhile or amount to not much more than rearranging the deck chairs on the sinking *Titanic*.

Undoubtedly, much more on this will be in the press in the future.

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April 23, 2002

Ms. Terri Harris
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Internal Revenue Service
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Dear Terri,

In my capacity as the President of the National Association of Buy Here, Pay Here Dealers which represents the interests of over 1500 independent dealer/members, I am submitting this issue and request for guidance pursuant to the Internal Revenue Service Industry Issue (IIR) Program.

Description of IIR Issue Background

Based upon industry statistics, it is estimated that the used car industry had approximately 60,000 dealers in 2001. Annual revenues attributable to used car sales in 2000 were estimated to be approximately $363 billion. Approximately 50% (30,000) of these used car dealers are independent buy here, pay here operators who self-finance the sales of used vehicles on retail sales contracts with terms of 1 - 5 years. Although a precise estimate is not available, I believe that at least 25% of these dealers (15,000) have annual sales of less than $ 1,000,000. These dealers sell vehicles to sub-prime customers who are unable to obtain traditional financing from banks but who comprise a significant portion of our domestic workforce and who use these vehicles for transportation to/from work.

Revenue Proc. 2000-22 allows small businesses with annual gross receipts of less than $ 1 million to change to the cash method of accounting. Revenue Procedure 2001-10 subsequently modified Rev. Proc. 2000-22 to clarify its application for tax shelters and small businesses with inventories.

Revenue Proc. 2002-22 allowed small businesses with annual gross receipts of less than $ 1 million to change to the cash method of accounting. On the surface, this ruling appears to eliminate the "immediate recognition" of the income requirement which has devastated dealers for many years. In reality, however, this procedure really provides no relief to buy here, pay here dealers because (down payments received at the time of sale must be immediately recognized as income under the cash method and) dealers also report finance sales (pursuant to installment contracts) into income as cash equivalents". So even if a dealer converts to the cash method, he will not benefit because the installment contracts are considered the "equivalent of cash". Under Treasury Regulations 1.1000-(1)(9) and 1.1274-2 the amount realized from a sale (recorded as income) is the amount financed. Applying the aforementioned rules in an

(Continued)

Ms. Terri Harris
Motor Vehicle Industry
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example, assume a vehicle with a cost of $ 4,000 is sold for $ 8,000 and the dealer receives $ 1,000 as a down payment with the $ 7,000 balance financed on an installment sales contract. Here is a comparison of the cash versus the accrual method:

	Cash Method	Accrual Method
Sales	$ 8,000	$ 8,000
Cost of Sales	(4,000)	(4,000)
Taxable Profit	$ 4,000	$ 4,000

As can be seen above, treating sub-prime finance contracts as "cash equivalents" under the cash method produces the exact same result as the accrual method! Given this answer there is absolutely no benefit from the use of the cash method! This does not seem consistent with the intent of Revenue Procedure 2000-22.

IIR ISSUE:

Sub-prime finance contracts from credit impaired customers have a high probability of default. The secondary market for such notes recognizes their high default rate and, therefore, it is common for such notes to be purchased and sold at significant discounts of up to 50%. Therefore, it seems unfair that buy here, pay here dealers are being taxed on money they may never receive even if they switch to the cash method. Under the present law, if a dealer finances the car he sells, he must recognize the entire profit at the time of sale, regardless of the size of his business even when there is a considerable uncertainty whether he will ever collect the installment contract. If left unchanged, the current law will significantly reduce the economic viability of the buy here, pay here business and dramatically decrease the number of used car dealers; thereby eliminating the most significant source of transportation available to the American workforce.

In these circumstances, the taxable profit from automotive retail sales contracts with sub-prime customers would more appropriately be recognized using the installment method, as they are collected. Revenue Procedure 2001-10 provides for the deferral of the deduction of the cost of the vehicle under the cash method until it has been sold. Therefore, the use of the installment method to recognize profit when collected, seems to provide a more appropriate measure of the economic reality of such transactions under the cash method of accounting!

Your consideration in this matter would be sincerely appreciated.

Sincerely,

Kenneth Shilson, CPA

Kenneth B. Shilson, CPA
President
National Association of Buy Here, Pay Here Dealers
Sr/mydocu/IRS/harris, terri, cash-accrual method issue

KBS/swr

METRO LEASING ... A REALLY GOOD CASE STUDY FOR ADVISORS TO DEALERS & DEALERSHIPS

In *Metro Leasing and Development Corp.* (T.C. Memo 2001-119), the fact patterns and issues for 1995 and 1996 relate to a variety of successful auto dealership scenarios that many practitioners are likely to encounter.

In *Metro*, the dealer previously sold off several other dealerships over a period of years while he continued to own all of the stock of a regular C corporation holding company. This holding company, in turn, owned all of the real estate and facilities used in the dealerships' operations. After the sales of the dealership operations, the former dealer's holding company (Metro) continued to collect rent on the dealership real estate and to hold other real estate, securities investments and receivables. One could say that Metro resulted from the metamorphosis of successful operating dealerships into a holding company after the sale of the operating assets.

In one sense, Metro represents a typical scenario likely to be encountered by advisors to dealerships that are at the point in their business cycle where they are fully matured and it's time for the current dealer to think about an exit strategy that allows him/her to transition out, but not entirely fade out of the picture.

Beyond that, after a dealership has been sold to successors, whether they are unrelated individuals or family members, often the selling entity–if it is a regular C corporation–may decide not to liquidate. Instead, it may remain in existence as a holding company.

Reasons favoring the continuation of the C corporation entity include (1) the desire to avoid the so-called double tax on C corp. liquidations, (2) the ability to discount the value of the corporate stock, (3) the flexibility to engage in a variety of recapitalization activities and/or strategies and (4) the expectation that by continuing the corporation in existence until the death of the former dealer/owner, at the dealer's eventual death, a step-up in basis for the stock (under current law) will be available to the surviving family members.

There's another common scenario where *Metro Leasing* can be instructive. That is the case of an active dealer who conducts his/her dealership operations in one corporate entity, while he/she owns another C corporation entity that owns the dealership facilities and rents them to the dealerships.

METRO LEASING & DEVELOPMENT CORPORATION V. COMM.

Typically, the general understanding is that if dealer owns the dealership realty, he/she is better off owning it personally and renting it directly to the dealership. In some instances, the dealer puts the realty into a corporation and that corporation elects S, flow-through, status. However, in many other instances, the dealership realty is owned by a separate corporation which the dealer controls and, for a variety of reasons, that corporation is a C corp. and is part of a brother-sister group of controlled corporations.

Taxpayers and their advisors in these situations can expect to be confronted with several critical tax issues. These issues include

TYPICAL ISSUES

1. How much compensation can be deducted as reasonable compensation paid to the key officers,
2. The holding company's potential exposure to the Section 531 penalty tax levied on the unreasonable accumulation of earnings and
3. Potential personal holding company issues under Section 541 (as an alternative to the Section 531 issues).

These interesting fact patterns and variations make *Metro Leasing* a classic case study for evaluating some of the issues facing dealers with exit strategies that involve similar situations. Better still, one can learn from Metro Leasing's (mis)adventures with the IRS what to expect if these troublesome tax issues can't be resolved at the agent level and eventually get into the Tax Court.

THE FACTS

The facts in this case are presented on pages 14-15.

As in any case (involving reasonable compensation) before the courts, the ***facts*** should not be taken lightly. The taxpayer and the IRS disagreed significantly over just what should be admitted as "facts" and what significance and/or inferences could be drawn from them. In Metro's case, many "facts" the taxpayer wanted to introduce were disputed or discounted by the IRS in its arguments and its briefs in setting this case up for the Tax Court.

THREE ISSUES

After negotiating as far as possible during the IRS audit of its 1995 and 1996 tax returns, Metro ended up with three issues for the Tax Court to decide. The first issue involving both years was how much compensation Metro could deduct under Section 162 as reasonable compensation paid to the former dealer and his wife, who were alleged to be the key employees of the holding company.

We have included detailed discussions of the Court's analysis of the traditional 5-factors and what a hypothetical independent investor might require in similar circumstances. Some of these analyses can be read later or skipped entirely if you're not interested in this extra detail right now.

The second issue–involving only 1995–was whether Metro was liable under Section 531 for the penalty tax–assessed at the highest individual income tax rate–because it had an unreasonable accumulation of earnings. In short, the IRS thought that Metro was accumulating earnings in order to avoid the double-tax on dividends.

The third issue involved both years, and it was whether Metro was subject to the 20% substantial underpayment penalties under Section 6662. This accuracy-related penalty issue was automatically raised by the IRS because of its disallowance of the large amounts Metro claimed as deductions for compensation. This disallowance automatically resulted in deficiencies larger than the minimum threshold necessary to trigger the penalty provisions.

Our discussions on the Section 531 penalty tax issues and the Section 6662 accuracy-related penalty taxes also include commentary suggesting planning considerations based on Metro's fate in the Tax Court.

THE TAX COURT'S SPLIT DECISION

The bottom line for Metro was that the Tax Court disallowed a substantial portion of the deduction it claimed for reasonable compensation. Actually, all facts considered, one might conclude that the Valentes, as key employees, came out pretty well on this issue.

The Tax Court held that Metro was liable for the Section 531 penalty tax for 1995. (The year 1996 did not involve this issue.)

Finally, the Tax Court declined to support the IRS's assessment of underpayment penalties for both years 1995 and 1996.

REASONABLE COMPENSATION ISSUE

Reasonable compensation is always an interesting issue. There is no shortage of cases each year across a broad spectrum of taxpayers and business environments. In relation specifically to auto dealers, previous *DTW* articles have analyzed this issue in the context of dealership deductions for payments to ***active*** dealers.

Metro Leasing takes on extra significance because it involves the latter stages of the business continuum, bridging the gap, so to speak, for dealers in transition. *Metro Leasing* specifically reflects back on the dealers' previous qualifications, business repu-

see ***METRO LEASING***, page 8

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tation, successes and compensation record when Mr. Valente was more actively employed by the dealerships.

However, the context in which this issue is raised for 1995 and 1996 involves the extent of the consulting services and activities actually performed by Mr. Valente during these years. The facts in the case include all the details of Mr. Valente's compensation for more than a decade, and it turns out that he was not undercompensated in prior years.

In attempting to justify the large compensation amounts for 1995-1996, Metro claimed that these amounts were paid, in part, based on Mr. Valente's prior and accumulated skills and experience. Note that this is different than claiming that Mr. Valente was not adequately compensated in prior years and that part of his 1995-1996 compensation was making up for his being undercompensated in earlier years. As a result, the amount of compensation Metro paid to Mr. Valente in 1995-1996 had to be justified solely on the merits of the services he actually performed in those years.

In one of two briefs filed by the IRS, it said, "Metro paid large, lump sum bonuses to George Valente and Lena Valente at year-end, rather than as any purported services were rendered. The amounts of the bonuses were determined by George Valente based on what he thought was fair. There is no evidence to show that the bonuses were related to any services performed. Metro distributed 26.7% and 57.1% of its total income as officers' compensation in 1995 and 1996, respectively. Metro's resulting negligible taxable income for the years at issue is an indication that the bonus system was based on funds available rather than on services rendered."

In this brief, the IRS agreed George Valente was a very successful businessman who, before he had retired in 1990, had owned a number of automobile dealerships and was highly compensated as an employee of these dealerships. Notwithstanding all of this, the Service argued that "...However, George Valente's outstanding qualities and prior high earnings do not relieve Metro from the burden of proving that the amount paid to George and Lena Valente as compensation (in 1995 and 1996) were reasonable and for services actually rendered."

What we see here is that the compensation deductions paid by Metro, the holding company, for 1995 and 1996 could not, in effect, ride on the coattails (i.e., be justified on the basis) of his prior services and compensation while he was actively a dealer.

In considering *Metro's* deduction for compensation paid to the Valentes ***as a team because of their joint efforts***, the Tax Court evaluated five (5) traditional factors in the format used by the Ninth Circuit Court of Appeals in *Elliotts, Inc.* (See pages 18-19.) The Court also applied an ***independent investor*** analysis to Metro's facts. (See pages 20-21.)

The Court said that the Valentes' services to Metro were "with the exception of the purchase and sale of assets during the years under consideration, essentially to maintain and collect the (Metro's) established and passive sources of revenue." The Court further concluded that it did not find it appropriate to rely ***solely*** on its independent investor analysis to reach its findings and/or holding.

LESSONS FROM THE (UN)REASONABLE COMPENSATION ISSUE

As a lesson for those looking to *Metro Leasing* for instruction, it should be noted that the Court said that the parties did not provide appropriate expert testimony ... or some methodology ... by which to decide the amount of compensation (bonus) that could be attributed to the results obtained through the Valentes' efforts. The Court ended up allowing somewhat more compensation as reasonable than the amount the IRS would have allowed for each year. However, the Court allowed Metro far less than the amounts it paid and claimed as deductions.

The obvious lesson is that taxpayers should be prepared to offer credible expert witness testimony in the Tax Court.

The bottom-line mindset of an aggressive taxpayer or a cynical advisor might look at this issue as simply reducing to: "Claim as much as you can ... Nothing ventured ... Nothing gained." *Metro Leasing* pushed the envelope and tried to get a deduction for as much compensation as possible. Understandably, the IRS resisted. In the end, the Tax Court turned out to be a little more generous.

A more analytic study of this case suggests a number of significant issues that tax advisors should take into consideration if they are involved with similar planning situations.

Metro Leasing appears to set forth a standard ... applicable to holding companies ... for determining the amount of reasonable compensation paid to a key executive or executives as a group. This standard involves the separate consideration of two elements. The first relates to the officers' efforts that were necessary and that were actually expended in the collection of an established stream of income. The second element involves a determination of whether there was an increase in the Corporation's income due to the judicious buying and selling of investment-type assets.

see ***METRO LEASING***, page 10

At A Glance	ISSUES & HOLDINGS METRO LEASING AND DEVELOPMENT CORP.		
	Taxpayer Claimed...	**IRS Allowed...**	**Tax Court Allowed...**
Reasonable Compensation ***How Much Could the Holding Company Deduct as "Reasonable Compensation" Paid to the Valente Husband & Wife Team?***	**1995** $60,000 Regular - Paid to Mrs. Valente $180,000 Year-End Bonus to Mrs. Valente $240,000	$77,000	$90,000
	1996 $ 60,000 Regular - Paid to Mrs. Valente $150,000 Year-End Bonus to Mrs. Valente $250,000 Year-End Bonus to Mr. Valente $460,000	$77,000	$163,000
	Total 2 years: $700,000	$154,000	$253,000
	• All things considered, Metro at least got something by going to the Tax Court. • However, an unexplained inconsistency between the facts and their application to the Tax Court's formula suggests that the Tax Court should have allowed Metro to deduct an additional $50,000. Did a clerical error creep in that no one ever caught in any of the review processes?		
Accumulated Earnings Tax ***Did the Corporation in 1995 Permit its Earnings to Accumulate Beyond the Reasonable Needs of the Business?***	• *YES...* Metro Leasing was liable for the accumulated earnings tax imposed by Section 531 with respect to 1995. • Metro was a "mere holding company" and prima facie had the purpose of avoiding the income tax on shareholders. • Metro was limited to accumulating no more than $250,000 without the imposition of the accumulated earnings tax. • In a follow-up Tax Court decision a year later, there were three technical issues concerning the interpretation of the penalty tax regulations and the penalty tax computation for 1995. All of these issues were resolved in favor of the IRS, and the Tax Court agreed with its computation of the accumulated earnings tax which amounted to approximately $56,000. (*Metro Leasing & Development Corp. v. Commissioner*, 119 T.C. No. 2, filed July 17, 2002.)		
Accuracy-Related Penalties ***Was Metro Liable for Substantial Understatement Penalties?***	• *NO...* Metro Leasing was not liable for accuracy-related penalties under Section 6662 for either 1995 or 1996. • Metro had relied on its accountant and that reliance was reasonable. • Metro's accountant, who testified at trial, was competent and fully informed.		
Deficiencies Assessed	• $450,000 income taxes - 1995 and 1996 combined • $109,000 accumulated earnings penalty tax for 1995 • $90,000 accuracy-related penalties - 1995 and 1996 combined		
Citation	• *Metro Leasing and Development Corporation, East Bay Chevrolet Company, a Corporation, v. Commissioner of Internal Revenue* • T.C. Memo 2001-119 (May 18, 2001), Docket Nos. 8054-99, 8055-99		

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In *Metro*, the Tax Court carefully documented the methodology and the computation process it followed in arriving at the amounts of additional compensation that it allowed over and above the $76,800 that the IRS would have allowed each year. All of this is discussed fully in the following attachments, and the Tax Court's computations appear on page 11.

All of this information has been presented in such a way that advisors can simply compare their own fact patterns to the frames of reference presented in each of the accompanying write-ups.

Both the IRS and the Tax Court accepted Metro's argument that the total deduction it should be allowed for reasonable compensation should be based on viewing or considering those amounts as having been paid to Mr. Valente and Mrs. Valente ***as a team.***

This "as a team" approach is certainly unique or novel. Do the facts really justify this result? (Students of U.S. history will recall that an argument could be made that the Valentes' situation was very similar to that which occurred during the latter stages of Woodrow Wilson's tenure as President of the United States.)

Metro Leasing is very helpful in the sense that practitioners can look at the Tax Court's reasoning, and perhaps from that, see opportunities where they can be more aggressive in determining compensation in similar situations.

One previous *Dealer Tax Watch* recommendation regarding multi-year compensation strategies is worth mentioning. This is the suggestion that the payout of compensation should be considered ... and possibly accelerated ... years in advance of the critical year. For a thorough discussion of this, see "Big 'Bonus' Before Buy-Out Wasn't 'Reasonable' ... How Not to Do It: *Twin City Dodge-Chrysler, Inc.*" (*Dealer Tax Watch*, June 1997).

WAS METRO SHORT-CHANGED $50,000?

In following the computation approach that the Tax Court laid out, it appears that someone's clerical oversight ended up costing the taxpayer an additional $50,000 worth of reasonable compensation for 1996. If the Tax Court had properly applied the numbers to its stated rationale, it appears that the reasonable compensation deduction for 1996 would have been $212,650 instead of $162,650.

It appears that this happened because the total of the components of income for 1996 which was $906,071 was repeated in another portion of the presentation of facts as $806,071 ... ***a difference of exactly $100,000.***

As it turned out, the Tax Court's "formula" for arriving at the additional reasonable compensation it allowed used the $806,071 lower amount instead of the *correct* total which was $100,000 higher. Since the Tax Court split the difference 50%-50% in determining the additional compensation it would allow, the taxpayer lost out on an additional $50,000 deduction due to this error or oversight. Or so it would appear!

The details of the computation are on the facing page.

SECTION 531 ISSUES & LESSONS

Quick question ... What is the number of the Federal form a CPA uses to compute the tax when a business unreasonably accumulates earnings? *Hint* ... this tax is assessed by Section 531. *Answer* ... There is no Form number ... because there is no Form for taxpayers to self-assess and fill out.

The Section 531 penalty tax is assessed by the IRS only if it decides that the taxpayer has gone too far in accumulating its earnings and should have paid out some dividends to its shareholders.

The Section 531 tax is applied at the highest individual income tax rate... 39.6%... to earnings accumulated beyond the reasonable needs of the business. The amounts permitted to accumulate depend on whether the taxpayer/business is an active business or whether it is ***solely*** or ***merely*** a holding company. Taxpayers that are mere holding companies are allowed to accumulate only $250,000.

With respect to Metro's liability for the unreasonable accumulation of earnings penalty tax, the Tax Court held that under traditional standards, Metro had not shown that its needs exceeded the $250,000 amount. The Court indicated that, although Mr. Valente testified about certain matters in this regard, "No steps had been taken or evidence been presented that corroborated these methods as established or reasonable needs."

Metro claimed that it was justified in accumulating its earnings to the extent it did because it anticipated that if Mr. Valente were not able to consult with one dealership that rented property and with another dealership that had purchased its property from Metro, these dealerships might default on their rental and/or principal obligations to Metro. Unfortunately for Metro, the Tax Court held that there was nothing in the record to support this conjecture.

The Court also said that the financial status of the automobile dealerships indirectly involved as lessees of the property owned by Metro Leasing was not available from the record. Here again are lessons–at Metro's expense–that this type of holding company has to take specific, concrete steps to initiate "future plans for development" and that all of this will require

see ***METRO LEASING***, page 12

TAX COURT'S CALCULATION OF ALLOWABLE REASONABLE COMP.

METRO LEASING V. COMM. (T. C. MEMO 2001-119)

	1995	1996		1996
Composition of Annual Income				
Interest Income	259,652	240,427		
Gross Rents	353,376	388,676		
Net Capital Gains	35,884	267,657		
Form 4797 Gains (Depreciation Recapture)	246,346	8,141		
Late Fees	2,931	1,170		
Total Income, based on detail	898,189	906,071**	(A)	**Recomputed Using Total Based on Detail**
Total income for 3 prior years (1992-94) ($604, 344) + (633,688) + (640,602)	1,878,634	1,878,634		
Average, based on 3 prior years (1992, 1993, 1994)	626,211	626,211	(B)	626,211
Total income for years involved, Per above	898,189	906,071	(A)	906,071
Unexplained Adjustment	290	(100,000)	(C)	
Amounts used by the Tax Court	898,479	806,071**	(D)	
Excess of total income for 1995 & 1996 over average for 3 prior years (Line D - Line B)	272,268	179,860	(E)	279,860
Adjustment by Court Income from Recapture of Depreciation (Form 4797 Gains), not considered to be a relevant increase by the Tax Court and, thus, factored out	(246,346)	(8,141)	(F)	(8,141)
Increased amount of income earned by the Valentes' efforts (Line E - Line F)	25,922	171,719	(G)	271,719
Division of increased earned income equally between officer/employee (50%) and the equity shareholder (50%)	50%	50%		50%
One-half (50%) allowable as additional compensation, described by the Court as "approximated additional compensation attributable to increase in income generated by the Valentes during 1995 and 1996." (Line G x 50%)	12,961	85,860	(H)	135,859
Above amount, as rounded	12,950*	85,850*	(I)	135,850
Add: amount determined by IRS/Respondent as base amount attributable to the Valentes' collection of petitioner's (Metro Leasing's) established income	76,800	76,800	(J)	76,800
Reasonable compensation allowed by the Tax Court (Line I + Line J)	89,750	162,650	(K)	212,650
Additional allowable compensation?				$50,000

* Bonuses allowed by the Tax Court: 50% if the increases in income for each year over the average of the 3 prior years, as adjusted to exclude the effect of depreciation recapture (Footnote 9 of opinion).

** The Tax Court's computation of allowable compensation used different total income amounts than those apparent from the detail. The 1996 computation was different by exactly $100,000. If the correct amount to use in applying the formula is $906,071, then the additional bonus allowable for 1996 would have been $50,000 greater as shown in the column at the far right..

(Continued from page 10)

credible (expert) witnesses to present this in the Tax Court.

PERSONAL HOLDING COMPANY ISSUES INEVITABLE...SOONER OR LATER

There's still another reason why *Metro Leasing* is a great teaching example. *Metro's* fact pattern presented for 1995-1996 will likely result in Metro having to deal with the personal holding company rules in subsequent years. The Personal Holding Company tax will not apply for any year when a taxpayer is already subject to the Section 531 penalty tax. But that's small consolation.

The personal holding company provisions were put into the Code to try to force corporations to pay out dividends. The Personal Holding Company tax under Section 541 is 39.6% of the corporation's undistributed personal holding company income. The most important fact for practitioners to know is that ***there is nothing wrong with being a personal holding company, as long as the corporation does not pay any personal holding company tax.***

The facts as presented in *Metro's* case for the years 1995 and 1996 did not result in Metro being classified as a personal holding company because of the composition of income that it reported each year. However, Metro very likely will be classified as a personal holding company in any subsequent year if it has either (1) only interest and/or dividend income, or (2) interest and/or dividend income ***and/or rental income which is less than 50% of gross receipts where adequate dividends are not paid out.*** This would be the case even if Metro were to have some lesser amounts of rental income because of the special personal holding company rules where rental income is concerned.

About the only steps a taxpayer can take in a situation like this is to either (1) become involved with some active business and/or (2) start paying out dividends at least in the minimum amounts necessary to negate any personal holding company tax liability.

If the corporation meets the definition of being a personal holding company, it can only avoid the PHCo tax if it has paid out appropriate amounts ***as dividends*** in either the previous years (using the dividend carryover provisions), the current year or after the close of the year (in limited amounts).

The personal holding company rules are extremely complex ... and are likely to be encountered where C corporations remain in existence as holding companies after the sale of their operating assets or while they hold rental properties and/or other investments.

Watch out especially for rental arrangements between related companies. Brother-sister and other related corporate rental groups operating as C corporations should be especially careful to consider the ramifications of Section 543(a)(6) ... *Use of Corporate Property by Shareholders* ... in their projections of personal holding company classification. Also, the special rule for classification of income received from personal service contracts ... Section 543(a)(7) ... should be taken into consideration where appropriate.

For a simplified, pro-forma example of a personal holding company classification determination where rental income is involved, see page 30.

Although personal holding company issues are not involved with the years presented to the Tax Court in *Metro Leasing*, they are clearly integral in advising regular Subchapter C corporation holding companies that remain in existence after their operating assets have been sold.

FINAL SUGGESTIONS

Cases like *Metro Leasing & Development Company* do not come along very often. *Metro Leasing* should be closely studied for its reasonable compensation, accumulated earnings tax and accuracy-related penalty tax issues.

In addition, practitioners can use this case as a guide in planning for C corporation dealers that are in transition, and who are likely to be selling their operating assets soon. Finally, *Metro Leasing* is also instructive if the dealer owns a C corp. which, in turn, owns and leases dealership facilities and collects rent on them.

We have included some planning lessons inspired by this case as a ***Practice Guide*** on the facing page.

Practice Guide

PLANNING LESSONS INSPIRED BY METRO LEASING

1. Adopt a longer range point of view. Cases like *Metro Leasing & Development Company* (T.C. Memo 2001-119) do not come along very often. *Metro Leasing* should be closely studied for its reasonable compensation, accumulated earnings tax and accuracy-related penalty tax issues. It should also be considered as a guide for a variety of C corporation dealerships in transition and for C corporation rental holding company situations.

2. Make a list ... or take an inventory ... of all of the salient dealer facts.

3. Compare this list with the facts in *Metro Leasing*. Be objective. How good are your facts, really? How similar are they? How different are they? How important would you argue the similarities and/or the differences are between your dealership situation and the fact pattern in *Metro Leasing*?

4. Metro's case was significantly impaired in the Tax Court because it failed to introduce credible and/or appropriate expert witness testimony with regard to (1) services actually vs. allegedly performed by key employees and (2) the company's plans for future expansion that would have justified its retention of earnings. Taxpayers should expect to be able to introduce persuasive fact testimony so that if they are involved with similar issues, the Tax Court will have a basis for reaching a favorable decision.

5. All of Metro's dealership facility leases were long-term net, net leases. Metro had no real management responsibilities in connection with the rental properties. The IRS and the Tax Court placed significant emphasis on the fact that in this case, the officers' efforts were minimal insofar as they related to the collection of an established stream of income. Perhaps by including some management responsibilities in lease agreements of this nature, other holding/rental companies may be in better position to argue that they are not "mere" holding companies, and/or that the amounts paid to key employees as compensation are really being paid for services rendered that involve more than just collecting rents. Are there services that the lessor can provide that can be included in the rental agreements? If so, is it reasonable and/or practical to do so?

6. Where dealerships have been fortunate enough to accumulate large amounts of cash and other liquid assets, start thinking about paying out as much as possible as reasonable compensation in advance of the years that will follow the sale of the operating assets. Note that in *Metro Leasing* the IRS and the Tax Court went along with the idea that the total compensation Metro paid to the Valentes was paid to them jointly or "as a team" as an undivided amount for their combined efforts. Has the dealer's spouse been adequately compensated for services rendered?

7. Become thoroughly familiar with Sections 531 and 541. Section 531 deals with the accumulated earnings tax, and Section 541 deals with the personal holding company tax. Both areas of the Code are extremely complex and are likely to be encountered where C corporations remain in existence as holding companies after the sale of their operating assets or while they hold rental properties and/or other investments.

   Watch out especially for rental arrangements between related companies. Brother-sister and other related corporate rental groups operating as C corporations should be especially careful to consider the ramifications of Section 543(a)(6) ... *Use of Corporate Property by Shareholders* ... and Revenue Ruling 84-137 (with its subjective criteria) in their projections of personal holding company classification. Also, the special rules for classification of income received from personal service contracts ... Section 543(a)(7) ... should be taken into consideration where appropriate.

8. Present your dealership client with a comprehensive, long-range planning scenario that anticipates what is likely to take place in the corporate entities in years after the dealership has been sold. How much income will be received? What will be the nature of that income? Your plan ... or better yet, these alternative plans ... should include safely navigating the corporations through the vexing and complicated provisions of Sections 531 and 541.

9. Don't place all your hopes on making one or two huge, fully deductible bail-outs of earnings in the guise of officers compensation or year-end bonuses. Instead, start planning for this need years in advance. Part of this planning should consider a long-range ... or multi-year ... plan or strategy for paying out compensation to avoid the burden of double taxation as much as is reasonably possible. However, be forewarned: There are no absolutes in this area.

   In addition, it should be expected that such plans may call for the payment of dividends to minimize reasonable compensation issues and personal holding company tax and/or accumulated earnings tax exposures. If dividends are going to be paid, then it would be wise to document how the amount paid out was determined and also to document the reasons for not paying out any more in order to justify the accumulation of retained earnings.

10. Consider what actions might be taken immediately or in the short-term (i.e., over the next few years) to strengthen the facts in your dealership and/or holding company situations while there is still time to take those actions. Don't wait until you're up against a wall and forced to take desperate or extremely aggressive measures. Life's too short ... the statute of limitations is too long ... and the Tax Court is too unlikely to be fooled.

At A Glance	FACTS TIMELINE METRO LEASING AND DEVELOPMENT CORP.
1959	• Mr. Valente first became involved in the automobile business
1959 - 1990	• Very successful dealer • At one point, owned 7 automobile dealerships and a leasing company • Over time, sold off all dealerships except one, Green Valley Ford
1990	• Sold last dealership, Green Valley Ford • Green Valley Ford did not own the real estate - land and buildings - that it used in its operations. This real estate continued to be owned by Metro Leasing (a successor in interest to East Bay Chevrolet Co.), and it was leased to Green Valley Ford. • Mr. Valente agreed to provide business consultation to the new owners and to "run" the profit-sharing plan.
1990 - 1994	• Metro continued to own the realty (land and buildings) used by two different dealerships, Green Valley Ford and South City Ford. • Facility leases were net, net, net, leases • Metro also had a small number of auto leases outstanding.
1995	• Metro sold the dealership realty used by South City Ford to that dealership in January, 1995. The sale was made on an installment basis. • After that sale, Metro's assets included: ▪ Dealership realty leased to Green Valley Ford ▪ Mortgage receivable, secured by dealership realty used by South City Ford ▪ Other land and a building in El Cerrito, CA ▪ 10 auto leases, all carryovers from prior years ▪ Other investments and receivables
1996	• Metro sold land and building/dealership realty used by Green Valley Ford to that dealership in 1996.
Mr. Valente's Consulting Services ... *Three Separate "Clients"*	• Mr. Valente was qualified to be involved in any aspect of the automobile business, including leasing realty to an automobile dealer and leasing automobiles. He was, in general, successful and experienced in business operations. • For the 12-year period from 1985 through 1996, Mr. Valente's highest annual wages exceeded $1 million. His average wages for that period exceeded $500,000. • However, after 1990 and before 1995, Mr. Valente's wages ranged from $152,000 to $320,000 ... and averaged $210,000. • Mr. Valente consulted for - and was separately compensated by - ***Green Valley Ford.*** • Mr. Valente also consulted with the dealership executives in connection with ***Metro Leasing's*** business operations. • Mr. Valente spent as much as 15 hours per week consulting. • Mr. Valente's expertise was also used in connection with the ***South City Ford*** property, consulting with that dealership's executives "to help ensure their continued ability to make mortgage payments" on Metro's self-financed sale of the property to the new dealer.
Compensation	• In 1995 and 1996, Metro paid Mr. and Mrs. Valente a total of $700,000. • The IRS would have allowed $154,000 over both years. • The Tax Court allowed a total of $253,000 for both years.
Citation	• *Metro Leasing and Development Corporation, East Bay Chevrolet Company, a Corporation, v. Commissioner of Internal Revenue* • T.C. Memo 2001-119 (May 18, 2001), Docket Nos. 8054-99, 8055-99

At A Glance	THE FACTS IN METRO LEASING
General Background	• Metro Leasing's principal place of business was in El Macero, CA, at the time the petitions were filed in these cases. Actually, Metro's place of business was in the Valentes' residence. • During 1995 and 1996, Metro had three employees ... Mr. and Mrs. Valente and Ms. Jo Ann Michaels, who was the corporate secretary and bookkeeper. • Ms. Michaels, as bookkeeper, deposited receipts, prepared checks, reconciled bank statements and maintained the books of account, including the general ledger and the cash receipts and disbursement journals. • During 1995 and 1996, George Valente was approximately 70 years old, and he was director and owned 100 percent of the common stock of Metro.
Mr. & Mrs. Valente ... as a Husband - Wife Employee Team	• Mr. Valente became ill in 1992. He suffered from cancer during 1995 and 1996. • Mr. Valente was somewhat disabled by and concerned about his condition, so he appointed his wife, Lena Valente, to be the President of Metro Leasing during 1995-1996. • During 1995 and 1996, Mrs. Valente was 66 and 67 years of age, respectively. • Even though he was ill, Mr. Valente remained active in Metro's business ***by means of a cooperative effort with Mrs. Valente.*** • Under that arrangement, Mr. Valente was the decision-maker, and Mrs. Valente executed his decisions. • Mrs. Valente became ill in 1996, retired at the end of that year, and she died in 1998.
Mr. Valente's Background & Connection with Green Valley Ford	• See *Facts Timeline* on facing page. • In connection with his sale of Green Valley Ford in 1990, Mr. Valente agreed to provide business consultation to the new owners and to "run" its profit-sharing plan. • The new owners of Green Valley Ford agreed to provide the Valentes with a new car each year. • In addition, in 1991, Mr. Valente received $20,444 of compensation from Green Valley Ford. For 1992, 1993, 1995, and 1996 he received $1,690, $2,851, $3,289, and $2,049, respectively. For 1995 and 1996, Mr. Valente received distributions of $55,307 and $76,076, respectively, from Green Valley Ford's profit-sharing plan.
Metro's Business Activities During 1995-1996	• Metro's business included the ownership of land and buildings leased to Green Valley Ford, under which the lessee paid the expenses associated with the property. The amount of rent was not based on dealership sales. • Metro was also engaged in the business of leasing automobiles and the purchase and sale of real property. It had approximately 10 automobile leases, all of which had been entered into prior to 1995. • Metro also owned several publicly traded stocks. • See *Facts Timeline* for detail of assets owned by Metro.
Compensation Matters	• For 1995, Metro deducted $240,435 as compensation to officers. This amount included a year-end bonus of $180,435. • For 1996, Metro deducted $460,000 as compensation to officers, including year-end bonuses of $250,000 to Mr. Valente and $150,000 to Mrs. Valente. • Mr. Valente determined the amount of compensation to be paid to officers based on the profitability of the business. • ***Because of their joint efforts, Mr. and Mrs. Valente's compensation was treated as an undivided amount for their combined efforts.*** • The facts also include a schedule of the Valentes' reported wages for the years 1985 through 1984. For 1985 and 1986, they reported approximately $500,000 per year. For 1987 through 1990, they reported wages of approximately $1 million per year. For the years 1991 through 1994, the reported wages were approximately $320,000, $150,000, $150,000 and $213,000, respectively. • The relatively large amounts of wages for the years 1985 through 1990 reflected compensation resulting from Mr. Valente's direct involvement with the successful operations of his automobile dealerships.
IRS Audit	• The IRS determined the amount of Metro's allowable deductions for reasonable compensation by use of - or by reference to - generalized statistics reflecting compensation for corporate officers in the equipment-leasing and real estate-rental businesses. • Based on those statistics, the IRS determined that Metro should only be entitled to a deduction of $76,800 for each year (1995 and 1996) as reasonable compensation for the Valentes' services.

DETAIL OF INCOME, OFFICER COMPENSATION AND OTHER RELATED STATISTICS
METRO LEASING AND DEVELOPMENT CORP.

	1987	1988	1989	1990	1991	1992	1993	1994	1995*	1996*
Gross Receipts	-	-	-	-	-	-	97,041	-	-	-
Dividend Income	$31,889	-	-	52	-	76	-	-	-	-
Interest Income	$7,132	17,257	12,676	67,435	68,561	61,719	92,276	99,624	259,652	240,427
Gross Rents	$448,955	489,234	438,105	446,349	458,648	460,311	379,566	534,373	353,376	388,676
Net Capital Gains	$19,117	17,400	30,814	38,393	419,187	84,830	52,194	-	35,884	267,657
Form 4797 Gains	-	-	-	17,301	-	(4,879)	11,075	5,520	246,346	8,141
Late Fees	-	-	-	-	-	-	-	-	2,931	1,170
Other	$106,484	60,058	22,264	-	-	2,287	1,536	1,085	-	-
Total Income	$626,991	583,949	503,859	569,530	946,396	604,344	633,688	640,602	898,189	906,071**
Total Income	$626,991	583,949	503,859	569,530	946,396	604,344	633,688	640,602	898,479	806,071**
Officer Compensation	$425,000	310,000	260,000	260,000	360,000	150,000	150,000	210,000	240,435	460,000
Compensation as Percentage of Total Income	67.8%	53.1%	51.6%	45.7%	38.0%	24.8%	23.7%	32.8%	26.7%	57.1%
Taxable Income	($171,253)	33,406	(19,237)	(5,402)	327,543	244,323	26,348	(36,327)	17,825	58,755
Adjusted Taxable Income	$285,636	343,406	240,763	273,871	692,945	394,376	176,348	173,673	294,587	518,755
Officer Compensation	$425,000	310,000	260,000	260,000	360,000	150,000	150,000	210,000	240,435	460,000
Compensation as a Percentage of Taxable Income	100.0%	90.3%	100.0%	94.9%	52.0%	38.0%	85.1%	100.0%	81.6%	88.7%
Dividends Paid	$0	17,600	10,560	11,241	60,000	10,000	10,800	0	0	0

* The years 1995 and 1996 were audited by the IRS and were at issue in *Metro Leasing and Development Corporation, East Bay Chevrolet Company, a Corporation, v. Comm.* (T.C. Memo 2001-119 (May 18, 2001), Docket Nos. 8054-99, 8055-99)

** No explanation is provided for reporting total income for 1996 in the decision facts table as $806,071 instead of $906,071. This unexplained inconsistency between the facts and their application to the Tax Court's formula suggests that the Tax Court should have allowed Metro to deduct an additional $50,000.

Metro Arguments

5 Factors, but Exclusive Reliance on Independent Investor Test

- Metro emphasized five traditional factors that the courts have used to decide whether compensation is reasonable...
  1. The type of services and their extent.
  2. The scarcity of qualified employees.
  3. Qualifications and prior earning capacity.
  4. The net earnings of the corporate taxpayer.
  5. The peculiar characteristics of the taxpayer's business.
- In addition, Metro contended that these five traditional tests were not adequate and would "invite arbitrary decisions" because of Metro's unique facts and circumstances.
- Therefore, Metro argued that the Tax Court should rely ***exclusively*** upon the "independent investor" test, in the same manner as used by the Court of Appeals for the *Seventh* Circuit.
- Metro wanted the independent investor test to be the sole method for deciding whether the compensation paid by Metro to its key officers was reasonable.
- Key citation: *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 835 (7th Cir. 1999), reversing *Heitz v. Commissioner*, T.C. Memo. 1998-220.
- In its reply brief, Metro defended its deductions for compensation in a general - almost ethereal - way. It said,

  "There are different approaches to business management as there are to life. One approach is the entrepreneurial, where the focus is on results and compensation is based on those results. Another approach is the bureaucratic, where the focus is on inputs rather than results. Compensation is based upon time and effort.

  "George Valente's management style for all of his business life has been not to focus on inputs, but rather on results. He was not used to determining executive compensation on the basis of time records and was impatient with the bureaucratic thought process. He knew from day-to-day what was being done in Metro and what needed to be done, and there was no one else in Metro to whom he was accountable or for whom he needed to document his activities.

  "Metro complied fully with the respondent's regulations dealing with required books and records. Its records of transactions were complete and adequate. So who is to say that George Valente's approach was wrong? What Metro did not maintain was documentation of George and Lena Valente's activities and thought processes. As an extremely small, closely-held corporation, what Metro did was adequate for its management needs. The courts have recognized before that such corporations, and even corporations much larger than Metro, cannot be held to the same strict formalities as larger corporations. ...

  "(Mr. Valente) felt that his efforts with Green Valley Ford were important in order for them (sic) to be able to pay Metro the rent on that property. He also felt that his work with South City Ford was important in order for it to be able to pay Metro the substantial amount it owed on its contract for the purchase of the dealership property.

  "That George Valente enjoyed doing what he did in connection with Green Valley Ford and South City Ford does not invalidate the fact that his activities furthered what was, in the opinion of Metro's management (i.e., of George and Lena Valente), a corporate objective."

Section 162	THE REASONABLE COMPENSATION ISSUE METRO LEASING AND DEVELOPMENT CORP.
IRS Arguments ***5 Factors Along with Independent Investor Test***	• The IRS argued that when payments are made to a corporate employee who is also a principal shareholder, the compensation must be reasonable in amount and have a purely compensatory purpose. (Citations omitted.) • The IRS emphasized case law from opinions of the Court of Appeals for the *Ninth* Circuit. (Not the Seventh Circuit, as stressed by the taxpayer.) In these cases, the Ninth Circuit traditionally considered five factors, none of which alone is decisive, in evaluating reasonable compensation … 1. The employee's role in the company. 2. An external comparison of the employee's salary with salaries paid by similar companies for similar services. 3. The character and condition of the company. 4. The conflict of interest between the company and the employee. 5. The internal consistency in the company's treatment of payments to employees. • The IRS argued that the "independent investor" test should be only one of the factors considered. • The Revenue Agent who examined Metro Leasing's tax returns, explained that he had determined reasonable compensation by literally turning that over to someone else … "I had basically referred that to our engineering group and they ran compensation. They have a program that does compensation for different activities. I gave them a couple of SIC Codes revolving (sic) equipment lease, or like he's leasing the autos, and rental properties. And he returned the value to me of an amount of compensation which I allowed on the return." Source: Metro's brief. • Metro contended that the evidence in the record was that the amount the IRS allowed as compensation ($76,800 per year) … "was derived from unidentified software analyzing an unidentified database relating to nonspecific SIC Codes. This is close to an admission (by the IRS) that the determination was arbitrary."
The Independent Investor Test ***Elliotts, Inc.***	• A relevant inquiry is whether an inactive, independent investor would be willing to compensate the employee as he was compensated. • The nature and quality of the services should be considered, as well as the effect of those services on the return the investor is seeing on his investment. • The corporation's rate of return on equity would be relevant to the independent investor in assessing the reasonableness of compensation in a small corporation where excessive compensation would noticeably decrease the rate of return.
How the Tax Court Approached the Issue	• The Tax Court said… "The parties disagree about the methodology to be used for measuring or determining the amount of reasonable compensation (under Section 162). ***They also rely on differing facts in applying the standards.*** • "The taxpayer's suggested traditional factors are, in essence, the same factors that the Court of Appeals for the Ninth Circuit has utilized." • The Tax Court analyzed the reasonable compensation issue in three steps or stages. 1. First, it evaluated the facts in the context of the five traditional factors, in the format used by the Court of Appeals for the Ninth Circuit. (See pages 18-19.) 2. Next, it evaluated Metro's facts in light of the independent investor test. (See pages 20-21.) 3. Third and finally, it had to decide whether it would be appropriate to ***solely*** rely on the independent investor test to the exclusion of its simultaneous analysis of the compensation in terms of the more traditional five factors.
Citation	• *Metro Leasing and Development Corporation, East Bay Chevrolet Company, a Corporation, v. Commissioner of Internal Revenue* • T.C. Memo 2001-119 (May 18, 2001), Docket Nos. 8054-99, 8055-99

Section 162

TAX COURT'S ANALYSIS OF METRO COMPENSATION BASED ON TRADITIONAL FIVE-FACTOR ANALYSIS ... WHAT THE TAX COURT SAID

In *Metro Leasing and Development Corp.*, the Tax Court analyzed five factors...

1. The employee's role in the company.
2. An external comparison of the employee's salary with salaries paid by similar companies for similar services.
3. The character and condition of the company.
4. The conflict of interest between the company and the employee.
5. The internal consistency in the company's treatment of payments to employees.

In addition to the above tests, the Tax Court's analysis of the hypothetical independent investor test is on pages 20-21.

#1. THE EMPLOYEE'S ROLE IN THE COMPANY

- We consider the Valentes as a single unit in the setting of this case because Mr. Valente was ill, and, although he was able to make decisions, it was Mrs. Valente who executed his decisions. Although a large portion of the compensation was paid to Mrs. Valente, the total compensation was based on the Valentes' joint efforts or performance, and we refer to that performance collectively and in the singular.
- The Valentes (initially Mr. Valente and then Mrs. Valente) were taken ill and became unable to fully function in petitioner's business. ***Petitioner's sources of income are of a passive or investment nature, in that income was generally received from established capital investment rather than from personal services.***
- Prior to 1995 and 1996, Mr. Valente sold his active operating interests in automobile dealerships and a leasing operation. Thereafter, operating out of the Valentes' home, petitioner's sources of income were mainly from investment type activity - ***collection of rent and interest and the purchase and sale of securities and realty.***
- Except for the ownership of a couple of parcels of land and some stock, petitioner's source of income was from the remnants of Mr. Valente's former ownership of automobile dealerships. Until the beginning of 1995, they owned realty that was leased to two different Ford dealerships. In the beginning of 1995, they sold one of the properties to the lessee and their income therefrom became income from seller-financing rather than from rental.
- Due to their age and physical condition, the Valentes were essentially semi-retired. During 1995 and 1996, Mr. Valente was recuperating from surgery necessitated by cancer, so that his ability to participate in petitioner's business activity was more limited than it had been in prior years.
- For the 4 years immediately prior to 1995 and 1996, the Valentes' wages or salary, including amounts received other than from petitioner, averaged just over $200,000. For 1995 and 1996, the years under consideration, petitioner compensated the Valentes in the amounts of $240,435 and $460,000, respectively. We note that ***for 1995 and 1996, the Valentes were more hindered by health and age than in prior years and unable to devote their full efforts to the business.***
- Mr. Valente's consultation to automobile dealerships which either leased from petitioner or for whom petitioner was mortgagor is thought by petitioner to be critical to the success of the automobile companies. ***We are not able to find that Mr. Valente's role was critical, especially because the financial condition of the dealerships was not made a part of the record.*** There is no indication that the dealerships that leased or purchased from petitioner were in financial difficulty or that petitioner's income stream was in jeopardy.
- Mr. Valente did, in any event, play a role in obtaining and maintaining the source of rental and interest income. We must note, however, that Mr. Valente received each year the use of a new automobile, monetary compensation, and relatively large profit-sharing distributions from the Green Valley Ford dealership.
- For the years 1995 and 1996, approximately 68% and 78%, respectively, of petitioner's income was from interest and rents derived from sources that were established prior to or at the beginning of the 1995 year. The majority of the remainder of petitioner's income was derived from the sale of property, both real and personal.
- Other than the Valentes, petitioner had only one employee, who was a clerical/bookkeeper. Accordingly, petitioner's financial success and the job of ensuring a continued income stream fell upon the Valentes.
- Although it was not shown that the automobile dealerships to whom land had been sold on installment contract or leased were in financial difficulty, ***petitioner has shown that, to some extent, Mr. Valente's efforts helped to ensure or maintain the income stream. Those same efforts also enhanced the capital structure of petitioner.*** In these circumstances, it is difficult to decide whether the Valentes' efforts were designed to generate income and/or to protect Mr. Valente's capital investment.

Section 162

TAX COURT'S ANALYSIS OF METRO COMPENSATION BASED ON TRADITIONAL FIVE-FACTOR ANALYSIS ... WHAT THE TAX COURT SAID

#2. AN EXTERNAL COMPARISON OF THE EMPLOYEE'S SALARY WITH SALARIES PAID BY SIMILAR COMPANIES FOR SIMILAR SERVICES

- On this point, respondent (i.e., the IRS) contends that Mrs. Valente would not be entitled to earn the amount petitioner paid her during 1995 and 1996. Conversely, petitioner (i.e., Metro Leasing, the taxpayer) argues that the compensation paid to Mr. and/or Mrs. Valente was for their joint effort.
- Admittedly, Mrs. Valente acted in the nature of an amanuensis for Mr. Valente; however, petitioner has shown that its payments were to the Valentes for their joint efforts. Our focus here is not on the question of who should report the income but on the amount deductible as reasonable compensation for the efforts of the operative officers of petitioner. See, e.g., *Lewisville Inv. Co. v. Commissioner*, 56 T.C. 770 (1971).
- Accordingly, we must evaluate whether the Valentes, acting together as petitioner's operative officers, earned the amount of compensation paid by petitioner. ***Neither party introduced evidence about compensation paid by similar companies for similar services.***

#3. THE CHARACTER & CONDITION OF THE COMPANY

- (The IRS) characterizes (Metro Leasing) as a small business with activities that are not complex. As noted, petitioner's income during the years in issue was from passive sources (rents, interest, and dividends), and respondent emphasizes that those sources did not require much effort by the Valentes.
- Respondent, however, acknowledges that the ***increases*** to petitioner's 1995 and 1996 income ***were attributable to gain on the sale of real property and stocks.*** Those increases, compared to the average of the prior 3 years, amounted to $25,922 and $171,719 for 1995 and 1996, respectively. Considered as a percentage increase over the 3 years prior to 1995, the increases were 4% and 27%, respectively.
- Petitioner contends that its assets were "interwoven with the retail automobile business" and that it was Mr. Valente's knowledge, expertise, and involvement that made petitioner financially successful.
- Petitioner acknowledges that the Valentes did not devote their full time to petitioner but argues that petitioner's success was nevertheless dependent upon the Valentes.

#4. THE CONFLICT OF INTEREST BETWEEN THE COMPANY & THE EMPLOYEE

- The question posed here is whether the Valentes used their control of petitioner to pay deductible salary, as opposed to nondeductible dividends. As contended by respondent, substantially all of petitioner's income was paid out in the form of compensation to the Valentes.
- ... There is a "general problem [in] ... distinguishing between dividends and compensation for services received by a shareholder-employee of a closely held corporation. What makes this situation troublesome is that the shareholder-employee and the corporation are not dealing with each other at arm's length. It is likely to be in the interests of both the corporation and the shareholder-employee to characterize any payments to the shareholder-employee as compensation rather than dividends."
- ... The petitioner paid out 26.7% and 57.1% of its gross income as compensation for 1995 and 1996, respectively. In addition, petitioner paid out in compensation to the Valentes' 81.6% and 88.7% of its taxable income before considering the compensation deduction for 1995 and 1996, respectively.

#5. THE INTERNAL CONSISTENCY IN THE COMPANY'S TREATMENT OF PAYMENTS TO EMPLOYEES

- Under this test, a company's formal compensation program is considered, and a comparative analysis is made of compensation to shareholder/employees in relation to compensation of non-shareholder employees.
- Petitioner had no such formal compensation program; instead, Mr. Valente would decide the amount of compensation on a year-by-year basis. Moreover, the only other employee of petitioner was a bookkeeper who did not have comparable qualifications, responsibilities, etc. Therefore, there was no way to compare payments to the key officers with payments to other management and/or rank-and-file employees.

Citation	• *Metro Leasing and Development Corporation v. Comm..* • T.C. Memo 2001-119 (May 18, 2001), Docket Nos. 8054-99, 8055-99

APPLICATION OF THE "INDEPENDENT INVESTOR" TEST TO METRO LEASING

Metro's Return on Equity

- Metro's return on equity, after subtracting the compensation it paid to the Valentes, was computed by the IRS as follows:

Year	Pretax income	After-tax income	*Equity*	Return on equity
1995	$17,825	$15,151	$2,013,692	.75 %
1996	58,755	49,066	2,028,715	2.42 %

- The amount of ***equity*** reflected consists of the total of the year-end balances in the capital stock, paid-in surplus, and retained earning accounts reported in the Schedule L balance sheet in the tax returns filed.
- For the year 1995, the $17,825 amount is the net amount after a deduction for a net operating loss carryforward from another year. Without considering the net operating loss deduction, the return on equity would have been 1.67%.

Return on Equity ... Metro's Position & Interpretation

- Metro did not dispute the IRS computations of the return on equity for 1995 and 1996 which were based upon the information reported in Metro's income tax returns.
- ***Metro's counterargument was that the Tax Court should focus on the return on equity in the form of appreciation of Metro's assets.***
- Based on Metro's calculation of the increases (appreciation) in the value of real estate and securities, its return on equity for 1995 and 1996 would have been much higher ... 34.5% and 36.5%, respectively.
- On the same basis, Metro contended that it had a 29% average return on equity for the years 1993 through 1996.

Return on Equity ... IRS Rebuttal & Interpretation

- The IRS contended that, after subtracting the compensation deducted by Metro, the return on Metro's equity was far less ... According to the IRS, Metro's return on equity was only .75% for 1995 and 2.42% for 1996. (See calculation above.)
- The IRS argued that Metro's approach to measuring the return on equity (34.5% and 36.5%) was speculative and overstated and that it did not match the amounts shown on its tax returns.
- The IRS contended that the return on equity should be measured based on realized income and not on unrealized appreciation of marketable securities and estimated average appreciation on the property it leased to Green Valley Ford.
- In the years when Metro had large capital gains from the sale of assets, it increased dramatically the amounts it paid to George Valente or to the Valente "team" as compensation. "Presumably, an independent investor would want to share the fruits of any asset appreciation."
- Another way the IRS put it was that "Metro is not a personal service business; its earnings were attributable to the use of its capital assets. An unrelated investor would expect to share in the gains on the disposition of corporate assets."
- In addition, the IRS noted that Metro did not factually establish that the real property had appreciated to the extent that Metro claimed it did.
- ***Significantly, there has been no showing in the record before the Tax Court that any portion of the claimed asset appreciation was due to the Valentes' efforts rather than it being due to the general change in market conditions.***

Reasonable Compensation	***APPLICATION OF THE "INDEPENDENT INVESTOR" TEST TO METRO LEASING***
Flaws in Metro's Reasoning	• Metro's approach included an inherent premise; i.e., that an independent investor would be satisfied with little or no return on Metro's current income stream that was being generated with little effort on the part of Metro's officers. • The Tax Court said it could not accept this premise. • Metro's approach included another assumption; i.e., that an independent investor would be willing to forgo an established stream of income cash-flow return on equity in return for the possibility that unrealized asset appreciation would be available in the future. • The Tax Court only partially agreed with that assumption.
What the Tax Court Said	• "To some extent, an independent investor might invest in an entity for the possibility of asset appreciation. That investor, however, would not, without some compelling reason, forgo the income stream from those assets. That is especially true where, as here, the Valentes' efforts were, in great part, directed at the maintenance, as opposed to the creation of the income stream." • "In fact, there is no evidence that the income stream (rental income and mortgage installment payments) was in jeopardy." • "While it is clear that the Valentes played some role in producing the 1995 and 1996 income increases over prior years, the increases were limited to the acquisition and sale of realty and marketable securities." • The Valentes' services to Metro were, with the exception of the purchase and sale of assets during 1995 and 1996, essentially to maintain and collect Metro's established and passive sources of revenue.
Tax Court Conclusion	• It was ***not*** appropriate for the Court to rely solely on the independent investor test in reaching a decision. • This took into consideration the facts that ▪ Metro Leasing failed to meet the independent investor test, ▪ The venue for any appeal by Metro Leasing would be to the Court of Appeals for the Ninth Circuit.
Citation	• *Metro Leasing and Development Corporation, East Bay Chevrolet Company, a Corporation, v. Commissioner of Internal Revenue* • T.C. Memo 2001-119 (May 18, 2001), Docket Nos. 8054-99, 8055-99

Reasonable Compensation	***HOW THE TAX COURT DETERMINED METRO'S DEDUCTION FOR COMPENSATION ...WHAT THE TAX COURT SAID***
Metro's Reliance on "Exacto Spring" Was Misplaced	• In its defense, Metro had relied considerably on *Exacto Spring Corp.* (*Exacto*) in supporting its compensation as reasonable. • The IRS pointed out that the compensated officer of *Exacto*, a fine wire and spring manufacturer, was a technical expert who was integrally involved in development of the automated machinery that was one of the reasons for *Exacto*'s financial success. • In addition, the compensated officer in *Exacto* was responsible for the solicitation of 60% to 70% of *Exacto*'s sales. • On the other hand, the Valentes' services to Metro were essentially involved with maintaining and collecting income from established and passive sources of revenue. • The Valentes' efforts were, in great part, directed at the maintenance, as opposed to the creation, of a stream of income. • In fact, there is no evidence that Metro's income stream (which consisted of rental income and mortgage installment payments) was in jeopardy, and while it is clear that the Valentes played some role in producing the 1995 and 1996 income increases over prior years, these increases were limited to (i.e., they resulted from) the acquisition and sale of realty and marketable securities.
Would an Independent Investor Settle for only 20%?	• During 1995 and 1996, Metro's adjusted taxable income (pretax and without considering net operating loss deductions from other years) was $294,587 and $518,755, respectively. • Assuming an independent investor would have been satisfied with a 20% return, then as much as $235,670 ($29,4587 x 80%) and $415,004 ($518,755 x 80%), for 1995 and 1996, respectively, would have been available for compensation of Metro's officers. • However, reasonable compensation cannot be based solely on allowing an amount that represented what was left after computing what was thought to be a fair return for an investor. • Under any measure of reasonable compensation, the amount must be for "personal services actually rendered." (*Elliotts, Inc. v. Comm. ... Exacto Spring Corp. v. Comm.*)
How Much Work Does It Take... Just to Collect a Regular Stream of Income?	• The facts in these cases reflect that a majority of Metro's income stream would have existed regardless of the Valentes' services or efforts during 1995 and 1996. The passive portion of Metro's income was well established and would continue with a minimum amount of effort. • Mr. Valente had been well compensated in prior years, reflecting that he had already been compensated for Metro's financial success prior to 1995. • Significantly, the Valentes were physically less able to devote their time and efforts to Metro's business during 1995 and 1996, yet Metro sought to justify substantial increases in the Valentes' compensation over the average of the prior 3 years. Their compensation for the past 4 years from Metro had averaged just under $210,000 per year. The increases over the average that they sought to justify were $30,000 in 1995 and $250,000 for 1996.
Tax Court Conclusions	• The Tax Court said, "...Although, there appears to be some justification for compensation in excess of the amount determined by the IRS, ***the amounts sought by Metro are unreasonable and unjustified on this record.***" • The profit from the acquisition and sale of realty and securities ... was more directly attributable to the Valentes' efforts. This, in turn, would justify some additional compensation. See "How Much More is Savvy Investing Worth?"

Reasonable Compensation	***HOW THE TAX COURT DETERMINED METRO'S DEDUCTION FOR COMPENSATION ... WHAT THE TAX COURT SAID***
Tax Court Allows Credit for Savvy Investing	• "The compensation paid to the Valentes represented 81.6% and 88.7%, respectively, of Metro's 1995 and 1996 adjusted taxable income. That would leave an independent investor with less than 20% and 10% of Metro's income for 1995 and 1996, respectively." • "An independent investor might or might not be willing to accept a division of "operating" profits that is not based on the extent to which the efforts, talents, or services of the officers were necessary for the generation of the profit. Those are the same aspects that we have considered to decide the amount of compensation that is reasonable." • "Accordingly, Metro must show here that the Valentes were compensated for services and that the compensation was reasonable; ***i.e., (Metro must show) that the officers ... were responsible for 81.6% and 88.7% of the profit.***" • "Metro has not shown that the Valentes' efforts in the collection of Metro's established stream of income would warrant any amount in excess of the annual $76,800 in compensation that the IRS has determined was reasonable." • Metro, has shown that the ***increases to its income*** for 1995 and 1996 due to the sale of assets during the 1995 and 1996 years ***were attributable to the Valentes' efforts***."
How Much More Is Savvy Investing Worth? ***Calculations Made by the Tax Court***	• The Valentes' efforts produced additional income in the amounts of $25,922 and $171,719 for 1995 and 1996, respectively. • ***Unfortunately the parties did not provide the Court with appropriate expert testimony or some methodology by which to decide the quantum of compensation (bonus) to be attributed to the results obtained by the Valentes' efforts.*** • Starting with the IRS's $76,800 determination as a base amount attributable to the Valentes' collection of Metro's established income, the Tax Court approximated ***an additional amount of compensation attributable to the increase in income*** generated by the Valentes during 1995 and 1996. • The Court calculated those amounts by dividing the increased amount of income earned by the Valentes' efforts between the officer/employee and equity holder (50% to each). It then added the 50% allocated to the officer/employee to the amount of $76,800 that the IRS had determined was reasonable. The total result was the amount allowed by the Court as reasonable compensation. • The Court allowed $89,750 and $162,650 for 1995 and 1996, respectively.
	• For the step-by-step calculations, see page 11.
$50,000 Oversight?	• ***Observation:*** The Tax Court fully explained its computations in two footnotes to the decision. However, no explanation was provided for reporting Metro's total income for 1996 in the decision facts table as $806,071 instead of $906,071 (i.e., the sum of the detail items listed). • This unexplained inconsistency between the facts and their application to the Tax Court's formula suggests that the Tax Court erred and that Metro should have been allowed to deduct an additional $50,000 for 1996. • Can anyone explain the $100,000 difference or account for this?
Citation	• *Metro Leasing and Development Corporation, East Bay Chevrolet Company, a Corporation, v. Commissioner of Internal Revenue* • T.C. Memo 2001-119 (May 18, 2001), Docket Nos. 8054-99, 8055-99

Section 531	**METRO'S LIABILITY FOR THE PENALTY TAX ON THE UNREASONABLE ACCUMULATION OF EARNINGS** **METRO LEASING AND DEVELOPMENT CORP.**
Section 531 Issues in Metro Leasing	• In general, the issue was whether Metro Leasing had permitted its earnings to accumulate beyond the reasonable needs of its business at the end of 1995. • The resolution of this issue involved two sub-issues: ▪ Whether Metro was a "mere holding or investment company" so as to not be entitled to accumulate income for reasonable needs beyond $250,000. ▪ If not, whether Metro had accumulated income beyond its reasonable needs.
General Background ... Relevant Code Sections	• The accumulated earnings tax is imposed on corporations "formed or availed of for the purpose of avoiding the income tax ... by permitting earnings and profits to accumulate instead of being divided or distributed." • This tax is imposed by Section 531, and it is an additional 39.6% of the amount of the Corporation's ***accumulated taxable income***. Note: This penalty tax rate is equal to the highest income tax rate applied to individuals. • Accumulated taxable income is adjusted taxable income less a deduction for dividends paid and less a deduction for the accumulated earnings credit. • The accumulated earnings credit in the case of a corporation which is a mere holding or investment company cannot exceed $250,000. [Sec. 535(c)(3)] • For corporations other than holding or investment companies, the credit is generally an amount equal to the part of earnings and profits that is retained for the reasonable needs of the business. • Note ... the amount of a corporation's ***"accumulated earnings and profits"*** is not the same as the amount of its "retained earnings" for accounting or financial statement purposes. ... See Section 316. • The term "reasonable needs of the business" includes the reasonably ***anticipated*** needs of the business. But, taxpayers and the IRS are always disagreeing over ... how much is enough? And ... what is or is not a "reasonably anticipated" business need? • Reg. Sec. 1.537-1(b)(1) provides that ▪ In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite and feasible plans for the use of such accumulation. ▪ Such accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending on all of the facts and circumstances relating to the future needs of the business. ▪ An accumulation ***cannot*** be justified on the grounds of reasonably anticipated needs of the business where ... 1. The future needs of the business are uncertain or vague, 2. The plans for the future use of an accumulation are not specific, definite and feasible, 3. The execution of such plan is postponed indefinitely.
Was Metro an "Active" Company or Was It a "Mere" Holding Company? *(Continued on next page)*	• ***Definition of Holding Company:*** A corporation is a "holding company" if it has "practically no activities except holding property and collecting the income therefrom or investing therein." [Reg. Sec. 1.533-1(c)] • ***Definition of Investment Company:*** If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of Section 533. [Reg. Sec. 1.533-1(c)]

Section 531	***METRO'S LIABILITY FOR THE PENALTY TAX ON THE UNREASONABLE ACCUMULATION OF EARNINGS*** ***METRO LEASING AND DEVELOPMENT CORP.***
Was Metro an "Active" Company or Was It a "Mere" Holding Company? *(Continued from previous page)*	• In its reply brief, Metro observed that "in ferreting out the true meaning of the term *mere holding or investment company*, the Courts have laid great stress on the use of the word ***mere***." • ...The presence of the word ***mere*** in the statutory language manifests an intention to draw a distinction between holding or investment corporations which are strictly passive in nature and those which engage in some measure of business activity." • The fact that any corporation is a mere holding or investment company shall be *prima facie* evidence of the purpose to avoid the income tax with respect to shareholders. [Sec. 533(b)]
Applying the Distinction to Metro	• The tax law makes a distinction between a "mere holding or investment company" and a corporation which is not. • The difference is that a mere holding or investment company is permitted to accumulate no more than $250,000. A company that is not a mere holding or investment company is permitted to accumulate a greater, unlimited, amount so long as that amount can be reasonably justified by its business needs. • Metro argued that it was not a mere holding or investment company. It claimed that its reasonably anticipated business needs at Dec. 31, 1995 justified the retention of $6.6 million. El Cerrito property development (discounted to reflect uncertainty) $ 2,000,000 East Bay mortgage/property redevelopment (discounted) 1,500,000 Section 303 stock redemption to pay estate tax 3,100,000 Total $ 6,600,000 • The IRS argued that Metro was a "mere holding company," and, therefore, it was only entitled to accumulate $250,000.
Metro's Limited Activities	• Metro held real property and stocks and received income from rent, interest, and the sale of stocks and real estate. • Some of Metro's income was from long-term (20-year) leases of real estate to auto dealerships. These leases were net, net leases. • ***Metro was not involved in operating or managing the rental properties.*** Metro had no responsibility for managing the properties. • Apparently, no evidence was introduced showing that Metro made any improvements to the Green Valley Ford property or to any other property that Metro owned during the years in issue. • The Tax Court said that Metro's situation was not, in any distinguishable aspect, different from that in *H. C. Cockrell Warehouse Corp. v. Comm.*, 71 T.C. 1036 (1979), where the taxpayer's income was derived from the rental of real property to operating companies. • There were only two findings of fact in the Tax Court record pertaining to the Section 531 issue... 1. Metro Leasing owned property in El Cerrito, which had been used as a parking lot, and Mr. Valente envisioned future development of the property. 2. Although Mr. Valente envisioned future development at a cost ranging from $7 to $10 million, as of 1995 and 1996, ***no plans had been made for development, nor had any action been commenced to initiate a formal plan to develop the property.***

Section 531	***METRO'S LIABILITY FOR THE PENALTY TAX ON THE UNREASONABLE ACCUMULATION OF EARNINGS*** ***METRO LEASING AND DEVELOPMENT CORP.***
Case Precedent & Indicia of Activity	• In *Dahlem Foundation, Inc. v. Comm.*, 54 T.C. 1566 (1970), the Tax Court explained that the use of the word ***"mere"*** was designed to draw a distinction between holding or investment corporations that are strictly passive...and those that engage in some measure of business activity. • In *H. C. Cockrell Warehouse Corp. v. Comm.*, the Tax Court described the activities that were sufficient to avoid "mere holding company" status. In addition, the taxpayer (i.e., Cockrell Warehouse Corp.), also actively managed other properties. ▪ Locating an undeveloped parcel of real estate for a shopping center. ▪ Negotiating and paying the purchase price of such undeveloped land. ▪ Securing leases for occupancy of the buildings to be situated in the shopping center. ▪ Arranging for a loan for construction of the shopping center. ▪ Various management functions with respect to the center. ▪ Maintaining and repairing various portions of the center.
Tax Court Holdings	• In *Metro Leasing*, the Tax Court said that it did not find Metro's activities "to approach those that this Court found sufficient to distinguish between a corporation that is primarily a "holding company" and one that is a "***mere*** holding company" in *Dahlem Foundation, Inc. v. Comm.*" • Therefore, Metro Leasing was a "mere holding company" within the meaning of Section 533(b), and *prima facie* had a purpose of avoiding the income tax on shareholders. • Metro Leasing "has not shown evidence of any purpose for its accumulation other than testimony about ***possible expansion and legal theories about possible needs***." • Metro was availed of for the purpose of evading the income tax on shareholders and was limited to accumulating, without imposition of accumulated earnings tax, no more than $250,000.
Weaknesses in Metro's Arguments	• It was unnecessary for the Tax Court to consider whether Metro had reasonable needs of its business in excess of $250,000. The Tax Court noted that under traditional standards Metro had not shown that its needs exceeded the $250,000 amount. • ***Weakness #1...*** Metro's needs were based on the ***speculation*** that Mr. Valente's future inability to provide consultation to the auto dealerships could result in defaults on obligations to Metro and that if these events were to happen, then Metro would have a need for (more) capital. • ***Weakness #2...*** The financial status of the automobile dealerships, was not available in the record before the Tax Court, nor was there any indication that such an event might create a need, without even considering whether it was "reasonable." • ***Weakness #3...*** Metro anticipated the death of the Valentes and the possibility of the need for a stock redemption under Section 303 to pay estate taxes. In rebuttal to Metro's contention, the IRS and the Tax Court observed that there would likely be no estate tax burden when the first of the Valentes died because of the unlimited marital deduction available for Federal estate tax purposes. • ***Weakness #4...*** In connection with Metro's Section 303 stock redemption contention, Metro's position was even more strained because Reg. Sec. 1.537-1(c)(1) provides that "the term *'Section 303 redemption needs'* means, with respect to the taxable year of the corporation in which a shareholder of the corporation ***died or any taxable year thereafter***, the amount needed, (or reasonably anticipated to be needed), to redeem stock included in the gross estate of such shareholder, but not in excess of the amount necessary to effect a distribution to which Section 303 applies." At the end of 1995, Mr. Valente - the sole shareholder of Metro - was still alive. Mr. and Mrs. Valente were both residents of California, a community property state. • ***Weakness #5...*** Mr. Valente had testified about the desire to develop a parcel of property which had been held by Metro for an extended amount of time. No formal plans or steps had been taken ... nor had any evidence been presented to the Tax Court ... that corroborated these matters as established or reasonable needs.
Citation	• *Metro Leasing and Development Corporation, East Bay Chevrolet Company, a Corporation, v. Commissioner of Internal Revenue* • T.C. Memo 2001-119 (May 18, 2001), Docket Nos. 8054-99, 8055-99

Section 531	METRO LEASING IN THE TAX COURT AGAIN OVER THE COMPUTATION OF THE SECTION 531 PENALTY TAX

Metro Leasing's Subsequent Section 531 Issues in the Tax Court

- After the Tax Court Memo decision in 2001, Metro Leasing contested the accuracy of the computation that the IRS made of its accumulated earnings penalty tax liability for 1995.
- The follow-up Tax Court decision came out in July 2002. The 2002 decision was not a Tax Court *Memorandum* decision, rather, it was a full Tax Court decision which indicates the importance of the technical issues that were presented for resolution.
- Metro raised three technical issues concerning the interpretation of the regulations. Metro contended that the accumulated earnings tax base for 1995, as computed by the IRS, should have been reduced by three amounts:
  1. "Deferred" tax attributable to the installment sale proceeds to be received by Metro Leasing in years after 1995.
  2. The amount of the income tax deficiency determined by the IRS which remained contested by Metro and for which Metro had made payment after filing its petition in the Tax Court.
  3. The difference between the amount of the tax liability reported on Metro's income tax return and the amount of tax that would have been due on Metro's net capital gain. In other words, this issue was whether the amount of the "tax attributable" adjustment to capital gains that is used to arrive at the accumulated earnings tax base should be limited to Metro's reported tax liability for the year 1995.
- All three interpretative questions were resolved in favor of the IRS.
- The Tax Court agreed that the IRS computation of the accumulated earnings tax for 1995 was correct. (See below.)

Computation of Penalty Tax for 1995

Accumulated Earnings Tax-1995

Taxable income per Form 5278		$325,000
Less Section 535(b) adjustments:		
1. Federal income taxes accrued		(2,674)
2. Net capital gains	40,354	
Less: Income tax attributable thereto	(15,738)	
	24,616	(24,616)
Subtotal (Note: Math error here discussed below)		300,384
Less dividends paid:		
Compensation treated as dividend		(150,250)
Other expenses paid for benefit of shareholders		(8,094)
Accumulated taxable income		$ 142,040
Applicable Section 531 penalty tax rate		x 39.6%
Accumulated earnings tax for 1995		$ 56,248

The above computation is taken directly from the Tax Court decision.

Possible Errors in IRS Computation

- In arriving at the subtotal of $300,384, it appears that the $2,674 attributable to the "Federal income tax as accrued" was not subtracted. The Tax Court said it was aware of this error.
- Note that the IRS computation of the penalty tax allows Metro Leasing a deduction for the disallowed (i.e., the unreasonable amount of) compensation paid in 1995 as part of a deduction for dividends paid. This compensation was paid to Mrs. Valente. Mr. Valente owned all of the outstanding stock of Metro Leasing.
- Section 562, which provides for the allowable deductions for dividends paid, indicates that preferential dividends may not be deducted. The IRS' allowance of the deduction for the excess compensation as a dividend would seem to be incongruent or inconsistent with Section 562 and Reg. Sec. 1.562-2(a).

Citation

- *Metro Leasing And Development Corp. v. Comm.*, 119 T.C. No. 2

Section 6662	***ACCURACY-RELATED PENALTY ISSUES*** ***METRO LEASING AND DEVELOPMENT CORP.***
Background ***Relevant Code Sections***	• Section 6662(a) imposes an accuracy-related penalty if any portion of an underpayment is attributable to negligence or disregard of rules or regulations or any substantial understatement of tax. • A substantial understatement for a corporation is an understatement that exceeds the greater of (1) 10% of the tax required to be shown on the return, or (2) $10,000. • ***Exception to the penalty:*** Section 6664(c) provides a "reasonable cause" exception ... The penalty will not apply to any portion of an underpayment for which there was reasonable cause for the position taken ***and the taxpayer acted in good faith.*** • The penalty tax rate is a flat 20% of the portion of the underpayment to which Section 6662 applies. • Metro's understatements exceeded the 10% or $10,000 threshold for 1995-96. • The issue was whether Metro was liable for accuracy-related penalties under Section 6662(a) for 1995 and/or 1996 ... or did the "reasonable cause" exception apply?
IRS' Arguments	• The IRS focused on the reasonable compensation aspects of the case. The IRS claimed that the Valentes did little or nothing to earn the $240,435 and $460,000 salaries and bonuses they were paid as a team. • The IRS took a very harsh approach in its initial brief ... "By ***negligently*** deducting distributions to the Valentes as compensation, Metro was able to minimize its tax liability. Also, Metro ***negligently*** retained substantial earnings for no apparent business reason." • In its reply brief, the IRS minimized the alleged efforts that Metro's CPA ... "Mr. Wood (Metro's CPA) testified that he reviewed bank statements, broker's advice sheets, leases and the general ledger. These documents would not disclose what sort of services the Valentes provided to Metro or reasons for any accumulations. Although Lena Valente did not have any apparent business experience and could not have earned that kind of money working for a stranger, Metro's CPA opined that the salary deductions claimed on the returns at issue were reasonable. ... ***This is unreasonable ... Metro's CPA could not articulate what services were provided by the shareholder-employees. Metro's purported reliance on (his - i.e., the CPA's) advice was unreasonable.***"
Metro's Arguments ***Was Metro's CPA More Familiar With the Issues Because He Did a Review Instead of a Compilation?***	• Metro contended that no penalty should apply here because of its full disclosure to, and reliance upon, a competent professional. ... i.e., the reasonable cause exception applied. • In its reply brief, Metro argued that its CPA had been involved to an even greater degree and was even more familiar with its tax positions because ... "his examination constituted a ***review*** and not merely a compilation, and he was not denied access to any information." • At trial, Metro's CPA testified that, as a result of doing a review (and not a compilation) of the financial statements, the review procedures familiarized him with all of the significant transactions of the corporation for each of the years involved. He testified that if he had done a complete audit, the only additional thing he would have done would have been to obtain third-party confirmations. • Metro's CPA testified at the trial in the Tax Court and said that ... ▪ He had discussed the matter of officers compensation with George Valente in connection with preparation of the Corporate tax returns. ▪ He had applied the independent investor test in reaching his conclusions that the compensation for 1995 and 1996 was reasonable and deductible. ▪ The independent investor analysis that he made showed that Metro had experienced an average annual increase in net worth for the two years (1995 & 1996) of 34.5%.
Tax Court's Finding of Fact	• Metro, through its bookkeeper and the Valentes, provided all relevant information to their accountant/CPA, Mr. Wood and relied upon his expertise and judgment in the preparation and reporting of Federal income.

Section 6662	ACCURACY-RELATED PENALTY ISSUES METRO LEASING AND DEVELOPMENT CORP.
Tax Court's Comments & Observations	• With respect to the reasonable compensation issue, the Tax Court said, "Although we have concluded that the value of their services was less than the amounts paid, we have found that the Valentes did play a meaningful role in the success of Metro. That is in contrast to the IRS's contention that the Valentes performed no services and/or did not play a meaningful role in the financial success of Metro. • "The adjustments we have considered in these cases are quite technical in nature (whether Metro was a "mere holding company" within the meaning of Section 533 and whether the Valentes' compensation was reasonable). • "Although our holdings are generally unfavorable to Metro, we are convinced that Metro relied on its accountant (CPA/Mr. Wood) and that reliance was reasonable. See *United States v. Boyle*, 469 U.S. 241, 251 (1985). • "Metro's accountant (CPA/Mr. Wood), who testified at trial, was competent, and he was fully informed of the factual predicate for deducting the compensation in dispute. His testimony regarding the compensation reflected that he was well informed. He relied, however, on factors that the Court ultimately found insufficient to carry the day." • Metro Leasing, a corporation, vis-à-vis the Valentes, had no tax expertise, and it was reasonable to rely on a fully informed and competent professional in the matters under consideration.
Tax Court Holding	• Metro Leasing was not liable for Section 6662 penalties for either 1995 or 1996.
Troubling Questions & Observations for CPAs as "Tax Advisors"	• Although the Tax Court let Metro off the hook as far as accuracy-related penalties were concerned, the Court really didn't analyze some of the arguments raised in the briefs ... or at least it didn't document its rationale for disposing of them. • As far as CPAs are concerned, Metro's assertion that its CPA issued a ***review*** opinion - rather than a compilation opinion - should not be passed off lightly. • Metro's CPA, Mr. Wood, testified that he had done a review, not merely a compilation of Metro's financial statements, and that had familiarized him with all of the significant transactions of the Corporation for each of the years involved. • ***Question #1...*** For purposes of fending off Section 6662 penalties by qualifying for the "reasonable cause exception under Section 6664(c) ... is it reasonable - or realistic - to assume that the CPA has been involved to a greater degree, or has more carefully scrutinized tax-related matters when that CPA's involvement with the financial statements is more than a ***"mere" compilation***? • ***Question #2...*** In being associated with ***reviewed*** financial statements, are CPAs inadvertently setting themselves up to be held more accountable or for a greater degree of familiarity - if not outright approval - of the (aggressive) positions that clients take in their tax returns? • ***Question #3...*** If a CPA is involved with ***audited*** financial statements, which purports to be the highest level of professional involvement ... in contrast with the lowly compilation ... is the CPA held to an even higher degree of acquiescence to positions taken in the tax returns? (Assuming no Schedule M adjustments are involved!!) • ***Question #4... How thorough should a CPA ... in his or her capacity as tax advisor ... be in documenting significant tax planning discussions with a client?*** The answer to this question relates not only to the appropriate level of documentation for the CPA's own practice liability purposes (should the client sue the CPA), but also to the possibility that this documentation might become evidence in the Tax Court should issues like Metro's be raised by the IRS on audit and accuracy-related penalty provisions automatically asserted against the client as a consequence.
Citation	• *Metro Leasing and Development Corporation, East Bay Chevrolet Company, a Corporation, v. Commissioner of Internal Revenue.* • T.C. Memo 2001-119 (May 18, 2001), Docket Nos. 8054-99, 8055-99

ABC DEVELOPMENT CORPORATION
PERSONAL HOLDING COMPANY STATUS / CLASSIFICATION
FOR THE CALENDAR YEAR 200X

Rental Income		
Building (Cash rents of $138,000 plus $27,831 gross up*)		$ 165,831
Interest Income	$ 1,620	
Dividend Income	8,858	
Total Interest & Dividend Income	$ 10,478	10,478
Ordinary Gross Income		$ 176,309
ADJUSTMENTS TO GROSS RENTS (Section 543(b)(2)(A))		
Depreciation		$ 21,959
Real Estate Taxes		18,000
Interest Expense		3,233
		$ 43,192

RENTAL INCOME MUST MEET BOTH TESTS IN ORDER FOR RENT NOT TO BE CLASSIFIED AS PERSONAL HOLDING COMPANY-TYPE INCOME

TEST #1

(1)	AOGI = Adjusted Ordinary Gross Income ($176,309-$43,192)	$ 133,117
(2)	Adjusted income from rents ($165,831 - $ 43,192)	$ 122,639
	Ratio of (2) to (1) must be over 50% in order to exclude rental income from PHCo. income category	92.1%

Question is: Does rental income (adjusted for depreciation, interest & taxes) exceed other investment income?

Answer: Yes, it does.

TEST #2

All PHCo. income other than rents (i.e., interest and dividend income, etc.)	$ 10,478
Less: 10% of Ordinary Gross Income	(17,631)
Subtotal	$ (7,153)
Less: Dividends - Paid in Cash during the year	(3,000)
= Undistributed Investment Income	$ (10,153)
If a positive figure, taxpayer must include rent as PHCo. income	NONE

Question is: Is undistributed investment income not more than 10% of Ordinary Gross Income?

Answer: It Is.

Personal Holding Company Test:

60% of Adjusted Ordinary Gross Income: 60% of $133,117 = $79,870

PHCo. Income of $10,478 is less than $79,870 (60% of Adjusted Ordinary Gross Income).

Conclusion: Therefore, ABC Development Corporation is NOT a Personal Holding Company for the year 200X.

Notes:

* Gross up is for property expenses (real estate taxes, insurance) paid by Lessees as part of net, net lease.

1. Amounts reflected in this sample calculation are not taken from *Metro Leasing & Development Corp.* These amounts are presented to illustrate calculations to determine personal holding company status where rental income (received from unrelated parties/lessees) is involved.
2. Watch out especially for rental arrangements between related companies. Brother-sister and other related corporate rental groups operating as C corporations should be especially careful to consider the ramifications of Section 543(a)(6) ... Use of Corporate Property by Shareholders ... and Revenue Ruling 84-137 (with its subjective criteria) in their projections of personal holding company classification.
3. Also, the special rules for classification of income received from personal service contracts ... Section 543(a)(7) ... should be taken into consideration where appropriate.

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