17 T.C. 566 (1951)

In determining the deductibility of compensation paid to shareholder-employees, the Tax Court will closely scrutinize the reasonableness of the compensation, especially in closely held corporations where the line between salary and disguised dividends can be blurred.

Summary

Kerrigan Iron Works, Inc., challenged the Commissioner's disallowance of certain deductions for the years 1941-1943, including salary paid to its president (the sole shareholder), truck rentals paid to the president, rent paid for a plant also owned by the president, and salary paid to the corporate secretary. The Tax Court considered whether these payments were reasonable business expenses or disguised distributions of profits. The court found some of the deductions excessive, adjusting them based on reasonableness considering the services rendered, market rates, and arm's-length standards. A deduction for 'labor relations expense' was disallowed for lack of substantiation.

Facts

Kerrigan Iron Works was a Tennessee corporation engaged in manufacturing. Philip Kerrigan, Jr., owned all its stock. During 1941-1943, the company shifted to war production, significantly increasing its revenue. Philip Kerrigan, Jr. was the president and treasurer, managing all aspects of the business. The company paid no dividends during these years. The company also rented trucks from Philip Kerrigan, Jr. In 1943, Kerrigan purchased a plant (Northside Plant) individually and leased it to the company. Regina Kerrigan, Philip's sister, was the corporate secretary.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against Kerrigan Iron Works for the tax years 1941, 1942, and 1943. Kerrigan Iron Works petitioned the Tax Court for a redetermination of these deficiencies. The Commissioner amended the answer, requesting an increase in deficiency in income tax for 1941 if any, which may result from the adjustment of petitioner's excess profits tax for that year in a recomputation under Rule 50 in accordance with the Tax Court's decision.

Issue(s)

1. Whether the compensation paid to Philip Kerrigan, Jr., was reasonable and deductible.

2. Whether the truck rentals paid to Philip Kerrigan, Jr., were reasonable and deductible.

3. Whether the rent paid for the Northside Plant to Philip Kerrigan, Jr., was

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reasonable and deductible.

4. Whether the salary paid to Regina Kerrigan was reasonable and deductible.

5. Whether the payment for ‘Labor Relations Expense’ was deductible.

Holding

1. No, because the full amount was not reasonable; the court determined a reasonable amount for each year.

2. No, because the full amount was not reasonable; the court determined a reasonable amount based on market rates and expenses.

3. No, because the full amount was not reasonable; the court determined a reasonable amount based on market rates and the circumstances.

4. No, because the full amount was not reasonable; the court determined a reasonable amount based on the services rendered.

5. No, because the taxpayer failed to prove the payment was not against public policy.

Court’s Reasoning

The court scrutinized the compensation paid to Philip Kerrigan, Jr., noting that payments to a sole shareholder require rigorous review. While Kerrigan’s management was valuable, the court found the full $25,000 salary unreasonable in 1941 and 1942, considering the company’s net income after taxes, sales, and the fact that no dividends were paid. The court emphasized that expert testimony is not binding. Regarding truck rentals and plant rent, the court looked to comparable market rates and actual expenses to determine reasonable amounts. The court reduced these deductions where they exceeded fair market value. Regarding Regina Kerrigan’s salary, the court found a portion was likely compensation for past services, which were gratuitous, and reduced the deductible amount. The court disallowed the

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