67 T.C. 694 (1977)

Payments to a controlling shareholder-executive of a closely held corporation can be deemed reasonable compensation and deductible business expenses, even in intra-family business arrangements, if supported by evidence of services rendered, fair market value, and legitimate business purpose.

Summary

Levenson & Klein, Inc. (L&K), a family-owned furniture retailer, was challenged by the IRS regarding deductions for compensation paid to its president, Reuben Levenson, and rent paid for a store leased from a related entity. The Tax Court held that Reuben's compensation was reasonable given his long tenure and contributions, despite his son, William, having equal pay and more operational responsibilities. The court also found the increased rent for the Rolling Road store to be deductible, accepting the business justifications for the intra-family lease amendment and stipulated fair rental value. Legal and professional fees related to a new store lease were deemed amortizable business expenses, not preferential dividends to the shareholder-employees. The court emphasized evaluating the totality of circumstances and recognizing the business realities of closely held corporations and intra-family transactions.

Facts

Levenson & Klein, Inc. (L&K) was a family-owned retail furniture business founded in 1919. Reuben Levenson was president and chairman of the board. His son, William Levenson, was vice president. The IRS challenged the deductibility of compensation paid to Reuben and rent paid by L&K for its Route 40 West store, which was leased from Rolling Forty Associates, a partnership owned by Reuben's daughters and William's trust. L&K also deducted legal and professional fees related to a new store and rezoning efforts. The IRS argued Reuben's compensation was excessive, the rent was not an ordinary and necessary expense, and the legal fees constituted preferential dividends.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in income tax for Levenson & Klein, Inc. and William and Gloria Levenson. The cases were consolidated in the United States Tax Court. The Tax Court reviewed the Commissioner's determinations regarding the reasonableness of compensation, deductibility of rent, and deductibility of legal and professional fees.

Issue(s)

1. Whether the compensation paid by Levenson & Klein, Inc. to Reuben H. Levenson was unreasonable and excessive, thus not deductible as a business expense under Section 162(a)(1) of the Internal Revenue Code.

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2. Whether the rent paid by Levenson & Klein, Inc. for its Route 40 West store was an ordinary and necessary business expense deductible under Section 162 of the Internal Revenue Code, or if it exceeded a reasonable amount due to the related lessor.
3. Whether certain legal and professional fees paid by Levenson & Klein, Inc. were deductible as ordinary and necessary business expenses or should be capitalized.
4. Whether the payment by Levenson & Klein, Inc. of certain legal and professional fees constituted preferential dividends to petitioners William and Gloria Levenson.

Holding

1. No, because based on the facts, including Reuben's qualifications, the scope of his work, and the company's success, the compensation was deemed reasonable.
2. Yes, because the rent paid, even in the intra-family lease arrangement, was considered an ordinary and necessary business expense, and the increased rent was justified and within fair market value.
3. Yes, in part. Legal fees related to the Pulaski Highway property are amortizable over the lease term. Fees for the abandoned Joppa Road property are fully deductible.
4. No, because the legal and professional fees were legitimate business expenses of the corporation and not preferential dividends to the shareholders.

Court's Reasoning

Reasonable Compensation: The court applied the multi-factor test from *Mayson Mfg. Co. v. Commissioner* to assess reasonableness. It emphasized Reuben's qualifications, long tenure (over 50 years), and significant contributions to L&K's success. Although William had equal salary and more operational duties, Reuben's experience and role in credit and collection (40% of the business), customer service, and overall corporate decisions justified his compensation. The court noted, "Not doubting William's valuable worth to the corporation, we will not equate 1 hour of a chief executive's time, having over 50 years of industry experience, with that of an executive with approximately 27 years of expertise." The lack of formal corporate approvals for Reuben's employment agreement was deemed less significant in a closely held corporation where informality is common. The court also found that the lack of dividends was not indicative of disguised dividends, considering L&K's financial position and need to reinvest in the business.

Rental Expense: The court acknowledged the close relationship between lessor and lessee but emphasized that the stipulated fair rental value of $100,000 per year for the Rolling Road store weakened the argument that the increased rent was to siphon off profits. The court accepted the petitioner's explanation of an oral agreement to increase rent when the store became profitable and the "package deal" where lease

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renewals for other properties were contingent on increasing the Rolling Road rent. The court quoted *Jos. N. Neel Co.*, stating, "it is entirely conceivable that the relations each with the other [of a family group], or their respective personalities, may be such that they will deal with each other strictly at arm's length." The court found the increased rent was a condition for continued possession and was reasonable.

Legal and Professional Fees: The court reasoned that because L&K leased the Pulaski Highway property on a net basis, and Pulaski Associates was formed solely to lease back to L&K, the economic reality was that L&K bore these expenses. Paying the rezoning, purchase, and lease legal fees directly was more efficient than Pulaski Associates paying them and increasing rent. Therefore, these fees are amortizable leasehold acquisition costs under Section 178(a). Fees for the abandoned Joppa Road property were deductible either as ordinary business expenses under Section 162 or as a loss under Section 165.

Practical Implications

Levenson & Klein provides practical guidance on deducting expenses in closely held, family-run businesses. It highlights that: (1) Reasonableness of executive compensation is determined by a totality of factors, including experience and long-term contribution, not just hours worked or operational duties. (2) Intra-family leases can be respected for tax purposes if the rent is within fair market value and supported by legitimate business reasons, even if negotiations are not strictly "arm's length." (3) Lessees can deduct or amortize expenses directly related to acquiring or improving leasehold interests, even if technically benefiting a related lessor, especially in net lease arrangements. This case underscores the importance of documenting business justifications for compensation, rent, and other related-party transactions and demonstrating that expenses are ordinary and necessary for the operating business.

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