

LEGAL UPDATE

CLIENT NEWSLETTER OF CARR, MORRIS & GRAEFF, P.C.

8300 BOONE BLVD
SUITE 250
TYSONS CORNER
VIENNA, VIRGINIA
22182
(703)288-2900

APRIL - MAY 2010

TAX

TOSSING OLD TAX RETURNS— NOT SO FAST!

Many tax advisers recommend that you hold onto copies of your finished tax returns forever. Why? So you can prove to the IRS that you actually filed. Yes, there is a statute of limitations (either 3 or 6 years), but it runs from the later of the due date, or the date you filed. If you can't prove you filed, you can't dispute the assessment.

As they struggle to balance their budgets, many states have turned to outsourcing their collections to companies who apparently have no access to state records. For example, the District of Columbia has outsourced the location of taxpayers who may not be registered for District taxes to a California company, MuniServices, LLC. At least in my dealings with them, it was clear that they had no idea what they were looking for. Whereas, the D.C. Office of Tax and Revenue sends out dunning letters to collect taxes already paid, but they had the name of the taxpayer right. I sent them the cancelled check and never heard back from them.

More recently, Virginia has begun dunning non-residents for assessments for years as far back as 1992. Two of our clients have received notices telling them, for the first time, that they owe money. One client was given a bill for \$138,900, allegedly for 2002. Fortunately, he had filed in 2002, both

continued on page 2

IN THIS ISSUE

TAX: Tossing Old Tax Returns— Not So Fast	1
TAX: Reasonable Compensation— Part II	1
COMMERCIAL/CRIMINAL: Antiboycotting Compliance: Increased Enforcement, Increased Exposure.....	2
BUSINESS/EMPLOYMENT: Is My Non-compete Enforceable?.....	3
STAFF NOTES	4

TAX

REASONABLE COMPENSATION — PART II

In the December 2009 – January 2010 issue of this publication, we discussed the factors the Internal Revenue Service (IRS) and the courts use to determine whether compensation is or is not *reasonable* under Section 162 of the Internal Revenue Code. Because these factors are nebulous we promised you we would discuss a recent case which would operationalize these factors. The case is important because it was decided by a three-judge panel of the U.S. Court of Appeals for the Seventh Circuit, which included two judges, Judges Posner and Easterbrook, who are leading lights in the “law and economics” movement which seeks to apply principles of market economics to court decisions with a financial impact. Judge Posner wrote the opinion.

In *Menard v. Commissioner of Internal Revenue*, 560 F.3d 620 (7th Cir. 2009), decided on March 10, 2009, the court was faced with the following facts: Menard, Inc. is a Wisconsin company which under the name of “Menards” trades in hardware and building supplies. In 1998 it had 138 stores and was the third largest retail home improvement chain after Home Depot and Lowe’s. It was founded in 1962 by John Menard, who was the company’s chief executive in 1998, the tax year at issue in the case. Menard worked 12 to 16 hours per day, 6 or 7 days per week, took only seven days vacation per year, worked while spending personal time with his family, involved himself in every detail of the company’s operation, and determined everyone’s compensation.

Under Mr. Menard’s strenuous management the company’s revenues rose from \$788 million in 1991 to \$3.4 billion in 1998. The company’s taxable income increased from \$59 million to \$315 million. The rate of return on shareholders’ equity in 1998 was 19%, greater than Home Depot or Lowe’s. Menard owned all the voting shares and 56% of the nonvoting shares. The rest of the stock was owned by family members, two of whom had senior jobs in the company. Like other

executives at Menards he was paid a modest base salary but participated along with them in a profit-sharing plan. In 1998 his salary was \$157,500, but he received a profit-sharing bonus of \$3 million. The bulk of this compensation, however, was a 5% bonus of \$17 million, which yielded total compensation in excess of \$20 million.

The 5% bonus was calculated as 5% of net income before income taxes and was adopted in 1973 by the company’s board at the suggestion of the company’s accounting firm, which thought Menard should have his own bonus plan because of his commanding role in the management of the company. The Tax Court, before whom the case eventually came, opined Menard’s compensation was excessive and was intended as a dividend because it was 5% of corporate earnings year in and year out.

The court held these were flimsy grounds given the fondness of the IRS and the Tax Court for a “totality of circumstances” approach. Menard’s compensation, which varied with the company’s profits, increased his incentive to work intelligently and hard to increase the profits on which his compensation was based. The Tax Court thought it was suspicious the board which approved the 5% bonus was controlled by Menard, but it could not be otherwise since he owned all the voting shares of the company. The logic of the Tax Court’s position would seem to be that a one-person corporation would not be allowed to pay its CEO any salary at all, which is untenable. Moreover, the fact the company paid no dividends is irrelevant as apparently it chose to retain all earnings to finance its expansion.

The Tax Court then compared Menard’s compensation with that of similarly situated CEO’s in 1998 to find out if his compensation was “objectively” excessive. That year the CEO of Home Depot was paid only \$3 million, although it was a much larger company than Menards. The CEO of Lowe’s, also a larger company, was paid only \$6 million. The Tax Court, however, ignored the substantial risk Menard took in having

continued on page 3

COMMERCIAL/CRIMINAL ANTIBOYCOTT COMPLIANCE: INCREASED ENFORCEMENT, INCREASED EXPOSURE

As discussed in a previous *Legal Update* issue dealing with the Foreign Corrupt Practices Act of 1977 (FCPA), increased international business opportunities for United States companies have led to enhanced enforcement of various federal regulatory statutes that provide for both civil and criminal penalties. The FCPA is one such statute, and we direct your attention to our June-July 2009 edition for an overview of its prohibitions and requirements.

Another international business area that has drawn greater enforcement scrutiny concerns U.S. statutes meant to curtail or prohibit U.S. individuals or companies from entering into agreements which would foster or participate in foreign business boycotts that the U.S. does not find in its interest and does not sanction. This *Legal Update* article will address the intent and the prohibitions of one such antiboycott statute contained in the 1977 amendments to the Department of Commerce Export Administration Act (EAA).

The Department of Commerce Bureau of Industry and Security is responsible for administering and enforcing the antiboycott laws under the EAA. These laws were adopted to prohibit U.S. companies from participating in foreign boycotts the U.S. does not sanction, with the intended effect of preventing U.S. companies from being used as a tool for implementation of foreign policies inconsistent with U.S. interests. In short, the EAA statute is meant to curtail participation of U.S. citizens and companies in other countries' economic boycotts or embargos with specific emphasis on not supporting the boycott of Israel sponsored by the Arab League. The antiboycott prohibitions of the Export Administration Regulations (EAR) are applicable to business activities of all U.S. persons involved in interstate or foreign commerce of the U.S. and cover both individuals and corporations.

Without getting into the nuances of EAA prohibitions and requirements, the following are illustrative of conduct that may be prohibited and subject to civil and criminal

penalties:

- Agreements to discriminate or actually discriminating against other persons based on race, religion, sex, national origin or nationality.
- Agreements to refuse or actually refusal to do business with or in Israel or with blacklisted companies.
- Agreements to furnish or to actually furnish information about the race, religion, sex, or national origin of another person.
- Furnishing information about business relationships with Israel or with blacklisted persons or companies.

Although this is not an exclusive list, it does provide examples of the type of activity which is prohibited. Businesses should be concerned about entering into agreements that contain language of prohibition or discrimination or which require the furnishing of information that is prohibited. Virtually all business activities are covered by the EAA antiboycott provisions; and, the prohibitions cover the sale, purchase, transfer or provision of goods and services between the U.S. and a foreign country, as well as transactions that occur entirely outside the United States. Contracts, letters of credit, requests for quotes or bids, purchase orders and other documents that are part and parcel of normal business transactions are subject to the prohibitions of the antiboycott laws. Significantly, companies should be aware that not only do the antiboycott laws contain prohibitions but they also impose specific reporting obligations—obligations with penalties for non-compliance. For instance the EAR requires U.S. individuals to report quarterly any requests they have received to support an unsanctioned foreign boycott.

The penalties for violating the EAA antiboycott laws can be substantial. Knowing violations can lead to a criminal fine of up to \$50,000 or five times the value of the export involved or up to five years imprisonment. On the civil side, administrative penalties can be imposed which could include a general denial of export privileges or fines up to \$11,000 per violation and/or exclusion from practice. Both criminal and civil penalties can be more severe in cases in which a violation of national security export controls

is involved.

The above is just a brief description of the antiboycott laws administered by the Bureau of Industry and Security of the Department of Commerce. Not only should all companies engaged in international business be aware of this law and its prohibitions and reporting requirements, such businesses should consider implementing a specific Corporate Compliance Policy. If your company is currently conducting business internationally, and if you have any questions or concerns, we invite you to contact us.

STEPHEN GRAEFF

TAX

Continued from page 1

Federal and in Virginia, and his accountant was able to furnish copies of the Virginia and federal filed returns showing no tax due. One has to ask, does Virginia even have a record of the client's 2002 filing? Why would they assess a compliant taxpayer \$138,900, out of the blue?

We have not yet resolved the claims from 1992 and 1995. It will be interesting, because very few people have records from 1992. Virginia claims one of the assessments was made in 1996, for \$1500, but now it has grown to \$12,000 with interest and penalties. Of course, tax assessments are presumed correct and it is up to the taxpayer to prove the assessment is wrong. How do you do that when you don't have records from 1992?

This recent experience has convinced me that you can never throw away tax returns and records of tax payments. As our tax and financial records transition to electronic records only, I believe that keeping a paper copy that will last for at least 20 years is an absolute necessity. You cannot rely on state tax authorities to keep these records, and you may well get unpleasant surprises from them 18 years after the fact, where the burden will be on you to prove that you filed and paid.

ROY MORRIS

Trivia answer: Larry Carr is a member of the Osage Nation. According to his Certificate of Degree of Indian Blood, Larry is 3/124 Native American. *The indecipherable balance is apparently a mix of uncertain European with a lean toward Irish.*

BUSINESS/EMPLOYMENT **IS MY NON-COMPETE** **ENFORCEABLE?**

Whether asked by the employer or the employee, the analysis is the same. To be enforceable, a non-compete provision must be reasonable to protect the employer's legitimate business interests.

Reasonableness is determined, in part, by looking at the geographic restriction and the duration of the proposed restriction. Non-compete agreements which either fail to specify geographic and durational restrictions or which contain overbroad geographic or durational restrictions are subject to being stricken by a court when enforcement is sought. Unfortunately, there is no bright line test to determine whether the geographic and durational restrictions are reasonable. Rather, you must look to the totality of the employee's relationship with the employer to determine what is reasonable. However, it is important to remember that courts will only enforce a restriction where the geographic and durational restrictions are as small as necessary to protect the employer's interest.

When looking to determine an appropriate geographic restriction in a non-compete agreement, the first step is to look at the geographic area served by the employer. Are the employer's clients local, regional or national? Does it matter to the employer's customers where the services are performed? The answer to these questions will help determine an appropriate geographic restriction. For instance, assume the employer is engaged in computer programming services. Typically, these services can be performed from any location, so a larger geographic restriction is appropriate; in this instance it is possible a nationwide restriction would be appropriate. However, if the services involved maintenance of small local area computer networks, the geographic restriction would be based on the location of the employer's clients – how far is it reasonable for the employee to travel to visit customer sites? In this instance a restriction equal to a 50-mile radius from the employer's offices may be appropriate.

In determining an appropriate durational restriction, the first step is to look at the frequency in which the employer's services are provided to customers. If services are provided to customers once a year, a restriction of 12-18 months may be appropriate. However, if services are provided on a weekly basis, a restriction of 3-6 months may be sufficient to protect the employer's interests.

In addition to the geographic and durational restrictions, the non-compete agreement must all also specify in detail the restrictions to be imposed on the employee. It is not reasonable for a business engaged in multiple unrelated product lines to attempt to impose a broad restriction on competition with *any* of its product lines where the former employee only provided services relative to and had information on one product line. Thus, it is important to limit the scope of the restriction so that only the legitimate interests of the employer with respect to the individual employee are protected. Thus, a restriction on competition must not attempt to prohibit a former employee from engaging in any business competitive with the business of the former employer. Rather, to be enforceable, the restriction must only preclude the former employee from engaging in a business competitive with the product line he was involved with when in the former employer's employ.

As non-compete agreements will only be enforced where the employer has a legitimate interest to protect, the employee must have special skills or knowledge about the employer's business or customers. Thus, non-compete agreements are frequently appropriate with salesmen or product development employees. Conversely, enforcement of a non-compete with a finance department employee (i.e., an accounts payable clerk) will be limited.

In sum, while most courts are initially skeptical about enforcing non-compete agreements, courts will enforce a properly written non-compete agreement if the agreement is reasonable given the business interests which are to be protected.

PHILIP SCHWARTZ

TAX, PART II

Continued from page 1

his compensation tied to earnings. Had the company lost money in 1998, Menard's total compensation would have been only \$157,500, "less than the salary of a federal judge," to quote the court's decision. The 5% bonus was in effect for 25 years before the Service pounced, because in 1998 Menard's had a very good year.

The Tax Court ruled any compensation paid Menard over \$7 million was excessive. It arrived at this figure via a complicated calculation which took into consideration the rates of return of Menard's *versus* the

two comparables and the compensation of Menard versus the compensation of the CEO's of the two comparables. The court held this calculation by the Tax Court was "arbitrary as well as dizzying" since it ignored differences in the full compensation packages of the three executives being compared, differences in the challenges faced by the companies in 1998, and differences in the responsibilities and performance of the three executives. For example, just two years after Menard received his questioned \$20 million, Home Depot hired a new CEO. He was paid \$124 million plus stock options during the ensuing six years and later received a severance payment of \$210 million.

The court observed that, given Menard's work habits ("workaholic, micromanaging ways"), Menard was probably working much harder than the CEO's of the comparable companies. For example, there were only three other corporate officers in addition to Menard. The Tax Court held since Menard owned the company he had all the incentive he needed to work hard without the spur of a salary; in other words, reasonable compensation for Menard should have been zero and he should have taken all his compensation as a dividend. The court observed there is no legal reason to treat shareholder-employees differently from non-shareholder employees. He or she is treated, for tax purposes, as two individuals: an independent investor and an employee. Otherwise, the corporate form of doing business would be totally ignored by the IRS.

The Seventh Circuit's decision in this case makes perfect legal and common sense. Certainly, shareholders are the best judges of optimal compensation for CEO's who are, in effect, their employees. In the case of Menard, who is both employer and employee, the analogy holds. Menard considerably reduced his tax bill and, therefore, increased his after-tax income by paying himself a high salary. But, it cannot be forgotten his company had a respectable return on equity and his compensation was fixed with a view to that return. It would indeed be perverse if an obsessively hard-working and successful businessperson such as Menard were to be penalized on an after-tax basis for producing superior business results. Yet, that would have been precisely the result if the Tax Court's decision had been allowed to stand.

In Part III of this article we will discuss reasonable compensation in the context of S corporations and Limited Liability Companies.

NÉSTOR CRUZ

CARR, MORRIS & GRAEFF, P.C.

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

The firm strives to provide full service representation to its corporate and individual clients. It is designed to provide such service by organization and presentation of an array of attorneys with diverse backgrounds in specialized areas of the law as well as a generalized background which enables them to look beyond a narrow specialty or need. The academic and cultural backgrounds of the attorneys of the firm are as diverse as their experience and specializations.

Carr, Morris & Graeff, P.C., specializes in the following areas: Corporate/General Business; Taxation/Estate Planning; Civil/Commercial litigation; Employment/Labor; Discrimination and Wage-Hour; Criminal; and Alternative Dispute Resolution.

The firm maintains its office in Tysons Corner, Virginia—the business hub of the metropolitan region. It has attorneys admitted to all of the local judicial jurisdictions.

STAFF NOTES

Carla Graeff won the office Final Four pool....again....by a wide margin.

* * *

CMG Trivia: Which CMG attorney is part Native American?

* * *

Vacations. Even the huge snow pile in the parking lot is gone... It's almost Summer, so where is everyone headed? *Listed in reverse order of perceived merit:*

- Roy Morris: bicycling in Provence, France
- Nestor Cruz: Enjoyed a Spring vacation in Palm Beach. Two weeks upcoming in Boca with a side trip to Miami for an all-class reunion of St. George's School (Havana)
- Justin Banford: fly fishing and bear dodging in Yellowstone National Park
- Steve Graeff: North Carolina-bound with mountains and outer banks as destinations
- Phil Schwartz: week in Duck, contemplating a brief sojourn across the Chesapeake Bay Bridge as well
- Dana Theriot: a week in Corolla
- Tom Berger: cruising on the Chesapeake
- Larry Carr: A week at Bethany Beach, short trip to Vegas for a wedding, a U-Haul move to Arizona (*good times*)

CARR, MORRIS & GRAEFF, P.C.
8300 BOONE BLVD, SUITE 250
VIENNA, VA 22182

PRSRT STD U.S. POSTAGE PAID Springfield, VA Permit No. 6082

RETURN SERVICE REQUESTED