

TERMINATION FOR CONVENIENCE AND PRINCIPALS' COMPENSATION

Reimbursement Limited to Documented Compensation

INTRODUCTION

The Armed Services Board of Appeals (ASBCA) recently held that, in a Termination for Convenience of the Government, reimbursement for the work of a closely held corporation's owners was limited to their documented compensation. In the *Magwood* case below, the Board held that the Owners were entitled to their documented compensation of **\$1.13/hr**. Principals of construction companies should take this decision into account when deciding how to report their compensation.

APPEAL OF MAGWOOD SERVICES

In the *Appeal of Magwood Services, Inc.*, ASBCA No. 59293, 14-3 BCA ¶ 35,599,¹ private corporation Magwood Services, Inc. entered into a fixed-price contract with the U.S. Army to replace two diversion holding tanks at an Air National Guard Base in Scotia, New York. Magwood was owned by Heywood Manigault, who served as president, and his wife Shirley, who served as office administrator.

During the course of the contract, several disputes arose which the parties did not resolve. The Army first terminated the contract for default, but later reversed itself and terminated the contract for convenience of the Government.

Pursuant to FAR 52.249-2, Magwood submitted a Termination Settlement Proposal on the federal Standard Form 1436. Magwood claimed cost items for reimbursement, including Mr. and Mrs. Manigault's time spent in resolving a performance security dispute. Mr. Manigault listed his time as president spent on settlement efforts as 27 hours at \$35 per hour, and Mrs. Manigault listed her time as office administrator for 32 hours at \$20 per hour.

The Board ruled that the number of hours claimed by Magwood's president and office administrator in resolving the dispute were reasonable, considering that Magwood exchanged 38 emails and additional discussions with the Government.

¹ See "Principals Paid \$1.13 Per Hour In Termination for Convenience," Construction Pro Network website, Oct. 24, 2014, at <http://constructionpronet.com/default.aspx>.

The Board ruled, however, that the compensation rates listed for Magwood were **not reasonable**, because the hourly rates of company principals must be documented, and cannot be based on fair market value. The only documentation of compensation in this case was a corporate income tax return that listed “Compensation of Officers” at \$4,694. The Board then calculated compensation rates based on 2,080 presumed annual working hours. By dividing \$4,694 by 2,080 hours, then dividing that amount between the two principals, the Board determined that Magwood could recover only the documented compensation for each: **\$1.13 per hour**.

On a separate issue, the Board held that Corporate G&A costs (indirect costs) must be allocated to “final cost objectives” (FAR 31.203(b)), which include contracts (FAR 31.001). Magwood had been performing on 9 other contracts when the Government terminated this contract for convenience. Therefore, Magwood was required to **allocate all of its G&A costs** among all of its active contracts. Because Magwood did not do so, it could not recover any of its G&A costs under this appeal.

This failure to properly document and report G&A expenses ultimately resulted in a \$40,504 hit for Magwood.

CONCLUSION

The takeaway from the *Magwood* holding is this: Closely held corporations commonly inflate the salaries of their principals so they can maximize deductions on their corporate tax return. In a termination for convenience settlement, these hourly rates may be reduced to match what a “reasonable” rate would be, based on fair market value.² However, **the opposite is not true** – salary rates of principals will not be adjusted upward to match a “reasonable” salary based on fair market value, but will be limited to documented compensation only.

In the end, you will be glad you made the call; by the way, it’s a FREE CALL.

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² See *Teems, Inc. v. General Servs. Admin.*, GSBICA 14090, 98-1 BCA ¶ 29,357.