Larry's Tax Law

Shareholder/Employee Compensation From The Personal Service S Corporation (Like The Personal Service C Corporation) Must Be Reasonable

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Introduction

Robert Southey's fairy tale, *Goldilocks and the Three Bears*, which was first published in 1837, provides tax practitioners with the proper analysis to determine whether compensation is reasonable. Compensation cannot be too high and compensation cannot be too low. It must be just right to be considered reasonable for tax purposes. Unfortunately, the determination is subjective in nature. Consequently, it may be subject to debate.

Code Section 162 is the starting point in every reasonable compensation case. Code Section 162 provides: There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--(1) a reasonable allowance for salaries or other compensation for personal services actually rendered***.

The Treasury Regulations, Section 1.162-7, expand the focus into 2 parts:

- The first part of the analysis is the "Intent Test." Under this test, the compensation payments must be intended to be made solely as payment for services rendered. In other words, the payments cannot be intended as consideration for anything other than for personal services.
- The second part of the analysis is the "Amount Test." Under this test, the compensation payments must be reasonable in amount. The payments cannot be greater in amount than what is reasonable under the circumstances for the services actually rendered.

Most S corporation reasonable compensation cases involve allegations of unreasonably low compensation. There are, however, at least four (4) circumstances where taxpayers may be motivated to pay unreasonably high compensation in the S corporation context, including:

- BUILT-IN GAINS TAX AVOIDANCE. The first circumstance is where a taxpayer wishes to avoid the application of the built-in gains tax under Code Section 1374 by zeroing out the corporation's taxable income determined as if it were a C corporation. Remember, the net recognized built-in gain under Code Section 1374(d)(2)(A) can never exceed the taxable income of the S corporation, determined as if it were a C corporation. So, if the taxable income of the C corporation is zero for the taxable year, there can be no built-in gains tax liability for the year. As a result of TAMRA 1988, however, if the taxable income for the taxable year is zero, the built-in gain gets carried over to future years and gets recognized to the extent of taxable income in the future years. But, if income is zeroed out for each of the remaining years during the built-in gains tax recognition period (by expenses such as compensation), the built-in gain tax is avoided forever. Under current law, Code Section 1374 (d)(7), the built-in gains tax recognition period is ten (10) years. As you recall, Congress shortened the recognition period to as little as five (5) years for tax years 2009, 2010, 2011, 2012 and 2013, in the name of economic stimulus. The law reverted back to ten (10) years on January 1, 2014. An interesting side note: Ways and Means Committee Chairman Dave Camp proposed, as part of his tax simplification legislation that he distributed to members of the House in early February of this year, to permanently reduce the recognition period to five (5) years.
- MAXIMIZE RETIREMENT PLAN CONTRIBUTIONS. The second circumstance is where the taxpayer wishes to maximize shareholder/employee earned income so that it may maximize contributions to a retirement plan. Retirement plan contributions are based on wages. Increasing wages allows the shareholder/employee to maximize the amount contributed to his or her retirement account.
- AVOID VIOLATING THE SINGLE CLASS OF STOCK REQUIREMENT. The third circumstance is where the taxpayer wishes to avoid violating the single class requirement of Code Section 1361(b)(1)(D). If the taxpayer desires to treat shareholders differently, it may attempt to use compensation to meet this objective. When that is done, the Service may throw out the reasonable compensation flag on audit to attack the validity of the S election. The Service generally only prevails in these cases when the fact pattern is egregious. Nevertheless, you need to be aware of the issue and be cautious so that compensation is reasonable and is paid for actual services rendered.
- AVOIDING THE APPLICATION OF CODE SECTION 1411. The fourth circumstance was given life by the Affordable Care Act. S corporation taxpayers may now be motivated to pay compensation to shareholders who do not actively participate in the business of the S corporation in an attempt to avoid the application of the 3.8% Net Investment Tax under Code Section 1411. This new 3.8% tax applies to what is called "net investment income." Included in the definition of "net investment income" is pass-through income from an S corporation in which the shareholder does not actively participate. So, if there is no colorable argument that the shareholder materially participates in the business of the S

corporation, there may be the motivation to pay wages to the shareholder. If the shareholder does not perform work for the corporation, the Service will be able to successfully attack the payment on the theory of unreasonable compensation.

Watson, P.C. v. U.S.

Watson, P.C. v. U.S., 668 F.3d 1008 (8th Cir. 2012), affirming 107 AFTR 2d 2011-311 (DC IA December 23, 2010), is an unreasonable compensation case in the context of a personal service S corporation. The taxpayer, David E. Watson, graduated from the University of Iowa with a bachelor's degree in business administration and a specialization in accounting. He became a CPA in 1983. In 1996, Watson incorporated DEWPC, a professional corporation, which elected to be treated as an S corporation. Watson is the sole officer, shareholder, director and employee of DEWPC. In 2003 and 2004, the tax years at issue, he was the only person to whom DEWPC distributed money. His annual salary in both years was $24,000. In arriving at his $24,000 annual salary figure, Watson had only considered what he thought he could pay an employee on a regular and continuous basis, regardless of the "seasonality" of the business or whether it was a good economy or bad economy. He did not consider what comparable businesses paid for similar services. During 2003 and 2004, Watson received distributions totaling roughly $320,000.

For each tax year, the Service reclassified $67,044 of the distributions as wages, stating DEWPC structured Watson's salary and distribution payments to avoid federal employment taxes. The Service's re-characterization resulted in a $48,519 employment tax assessment against DEWPC. After making a few payments toward the assessment, DEWPC filed a claim for refund. The IRS denied the claim and DEWPC sued in the US District Court for the District of Iowa, located in Des Moines, about 1 hour and 45 minutes away from Iowa City, the home of Watson's alma mater, the fighting University of Iowa Hawkeyes.

The District Court held in favor of the Service. It reasoned that Watson was an exceedingly qualified accountant. He has both a bachelor's degree and an advanced degree, and approximately 20 years of experience in accounting and taxation. During 2002 and 2003, Watson worked approximately 35 to 45 hours per week for his reputable and well-established firm which had over $2 million and nearly $3 million in gross revenue, respectively, during those years. The court further reasoned that any reasonable person in Watson's role as DEWPC's sole shareholder, officer, and employee would have earned more than $24,000, particularly in light of the large distributions he received. Based on these facts and circumstances, the court was convinced that DEWPC structured Watson's salary and dividend payments in an effort to avoid federal employment taxes, with full knowledge that the distributions to Watson were actually "remuneration for services performed."

Watson appealed the District Court decision to the Eighth Circuit Court of Appeals, where he asserted at least two alternative positions:

- The government's expert on the issue of reasonable compensation should not be relied upon; and
- The focus should be on the corporation's intent with respect to compensation rather than on the reasonableness of compensation.

After much discussion, the Eighth Circuit found both of the taxpayer's arguments meritless.

DEWPC asserted the government's expert, among other things, was not qualified to render a reliable opinion on reasonable compensation. He was a certified business valuation analyst, but had no credentials specifically relating to compensation. The court concluded the taxpayer's argument was not convincing. The expert was an experienced "general engineer" for the IRS; he spent 40% of his time dealing with compensation issues. In fact, he had worked on 20 to 30 reasonable compensation cases. In accordance with Rule 702 of the Federal Rules of Evidence, a witness may qualify as an expert by "knowledge, skill, experience, training or education."

DEWPC also argued the government's expert witness should not be relied upon because he changed his opinions during the lower court proceeding, failed to consider important facts in rendering his opinion, and he adopted flawed methods to arrive at his conclusions. Unfortunately, DEWPC never raised these objections in the lower court, nor did it introduce evidence through its own expert witness to contradict the government's position.

To address DEWPC's second argument, the Eighth Circuit surveyed the cases on reasonable compensation. "[A] business may deduct a 'reasonable allowance for salaries or other compensation for services actually rendered' as ordinary and necessary business expenses." The determination of reasonableness requires an analysis of all of the facts and circumstances. The lower court considered the relevant facts and circumstances. Nevertheless, DEWPC asserts, rather than focus on reasonableness, the court should have focused on the taxpayer's intent; that is—did the taxpayer have compensatory intent in making the distributions to Watson?

The court quickly set aside the taxpayer's argument. It stated a deduction for compensation is allowed if it is reasonable and the payments are for actual services rendered. Citing the Ninth Circuit Court of Appeals in *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1243 (9th Cir. 1983), the court concluded the reasonableness inquiry is so broad, it most often subsumes the intent inquiry. The lower court correctly analyzed the matter with its focus on reasonableness.

Last, DEWPC argued the lower court should have applied the principles of *Pediatric Surgical Assocs., P.C. v. Commission*, T.C. Memo 2001-81 (2001). DEWPC specifically asserted Watson's reasonable compensation should have been limited to his personal billing receipts less expenses attributable to those receipts. The Eighth Circuit quickly pointed out that Watson was not the only person generating revenue. Non-shareholder employees were also generating revenue. So, merely focusing on Watson's personal time-keeper receipts and expenses attributable thereto was not appropriate in this case. Other evidence is relevant to the inquiry of reasonableness. This additional evidence likely includes, but is not limited to, business generated by the shareholder employee, and his/her experience, expertise, hours worked, and education; lack of arms-length negotiation; compensation history; and the financial ability of the corporation.

The Eighth Circuit concluded the lower court's decision was based upon the proper legal standards. It was affirmed.

The court totally ignored the analysis adopted by the US Tax Court in *Pediatric Surgical Associates* (discussed below) and concluded that you do not simply look at the income derived from the shareholder/employee's personal services less a reasonable allocation of overhead to conclude what constitutes reasonable compensation. Rather, the Eighth Circuit, recognizing that closely held businesses do not run themselves, took a much broader view and concluded you must look at all of the facts and circumstances, including:

- the business generated by the shareholder/employee;
- the shareholder/employee's experience and expertise;
- the number of hours worked by the shareholder/employee;
- the shareholder/employee's education;
- the non-income generating services performed by the shareholder/employee (such as management services, business marketing activities and administrative services);
- the compensation history of the shareholder/employee (was he or she undercompensated in prior years);
- the financial ability of the corporation to pay; and
- the compensation paid to similarly skilled and experienced employees in similar corporations within the same geographic region.

Watson stands for the proposition, at least in the Eighth Circuit, that you take a broader view (even in sole service provider cases), and focus on all of the facts and circumstances to determine what constitutes reasonable compensation. The US Tax Court, as suggested by it in *Pediatric Surgical Associates*, seems to take a much narrower view in professional service

cases, especially where the corporation employs both shareholder and non-shareholder employees.

While taxpayer motivations are generally the same in the context of personal service corporations as they are in the context of business corporations, these added wrinkles increase the complexity of the analysis as to what constitutes reasonable compensation. Personal service corporations, however, create a unique dilemma when looking at reasonable compensation. In both the C and S corporation contexts, if the income of the corporation is derived solely from the services of the shareholders, any attack by the Service that the compensation being paid to the shareholders is too high will not be very strong. On the other hand, in the S corporation context, if the income of the corporation is derived solely from the services of the shareholders, the shareholders will have a difficult time justifying low compensation and high distributions.

RADTKE

Radtke v. United States, 63 AFTR2d 89-1469, 712 F.Supp. 143 (1989), aff'd per curiam, 65 AFTR2d 90-1155, 895 F.2d 1196 (7th Cir. 1990), is a case involving an attorney who was the sole billing service provider for his wholly-owned S corporation. While the case is extreme in its facts, it illustrates the fact that, in the case where a shareholder provides all of the services for the corporation, low compensation will not prevail.

Mr. Radtke took all of the profits from the corporation as distributions. He paid himself zero compensation. Mr. Radtke worked full-time for the corporation. No other service providers generated income for the corporation. The old adage, pigs get fat and hogs get slaughtered, definitely applied to this case. As you would suspect, Mr. Radtke got slaughtered by the court. The Service knocked him out in the first round. He should have stayed down for the count rather than get himself humiliated by the District Court for the Eastern District of Wisconsin and again by the Seventh Circuit Court of Appeals.

In the case where the personal service corporation employs non-shareholders who generate income for the corporation from their services, we encounter another dilemma – whether the reasonable compensation of a shareholder/employee may exceed his or her personal service collections, less a reasonable allocation of overhead. In the C corporation context, the US Tax Court was faced with this situation in *Pediatric Surgical Associates*.

Pediatric Surgical Associates

Pediatric Surgical Associates, P.C., TCM 2001 -81, involved a Texas professional corporation that employed four (4) shareholder/employee surgeons and two (2) non-shareholder/employee surgeons. The surgeons were the only income generating employees of the corporation. Upon

audit, the Service argued that a portion of the compensation paid to the shareholder/employee surgeons was actually distributions of profits; that is, profits attributable to the services of the non-shareholder/employee surgeons. On audit, the IRS also threw out a Code Section 6662 penalty flag.

The taxpayer appealed the case. After not receiving a warm welcome in the Office of IRS appeals, the taxpayer filed a petition in the US Tax Court.

It turns out, Judge Halpern was not much friendlier to the taxpayer than the auditor or the IRS appeals officer. Writing a 35-page opinion, the court upheld the IRS assessment of both the taxes and the accuracy related penalty.

The tax years at issue were 1994 and 1995. The aggregate tax and penalty at issue was around $600,000, plus or minus a few dollars. The Service disallowed around $600,000 of compensation in 1994 and $800,000 of compensation in 1995. In the US Tax Court, the Service retreated from its audit position and agreed to reduce its compensation disallowance from $600,000 in 1994 to $140,000 and from $800,000 in 1995 to $20,000. But, it did not walk away from the Code Section 6662 penalty. Rather than accept the concessions offered by the IRS and call it a day, the taxpayer continued to fight it out in the US Tax Court.

The Service's position was simple: A portion of the amount claimed by the taxpayer as a deduction under Section 162 for compensation paid to shareholder/employees was disguised dividends. It was profits attributable to the services of the non-shareholder/employees. The court ultimately agreed with the IRS.

In a rather strange opinion, the court focused its analysis on the collections of the taxpayer during the tax years at issue directly attributable to the services of the shareholder/employees and the overhead properly allocable to the shareholder/employees. The court held that, in the personal service context, a shareholder's collections, less a reasonable allocation of overhead, is the proper method to determine the shareholder/employee's level of reasonable compensation.

So, the US Tax Court ruled that the amount paid as compensation to the shareholder/employees of Pediatric Surgical Associates, but attributable to the income generated from the services of non-shareholder employees, was not reasonable. Judge Halpern completely ignored the fact that shareholder/employees do more than just bill for their patient or client services. They build the goodwill of the organization, and they actively participate in administrative matters such as recruiting and hiring professional and nonprofessional staff, overseeing management, finance and operations, and training professional staff.

This case is cited often for the proposition that, in the context of professional service businesses that employ both shareholder and non-shareholder professional service providers, we must look at each shareholder/employee's personal billing receipts, less a reasonable allocation of overhead, to come up with what constitutes reasonable compensation for that shareholder/employee.

Many commentators believe the US Tax Court's decision in Pediatric Surgical Associates is wrong. Nevertheless, you need to be aware that the case is out there. You need to consider its implications when advising clients.

Conclusion

Each case requires an analysis of all facts and circumstances. Unfortunately, there is no bright line test. After an audit commences, tax advisors are quite late in the game; the facts are etched in stone. At that point, you have to search the facts and be ready to present all of the facts surrounding your case. Hopefully, the good facts overshadow the bad facts.

Tags: Reasonable Compensation