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Unreasonable Compensation in the Professional Corporation

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UNREASONABLE COMPENSATION IN THE PROFESSIONAL CORPORATION

INTRODUCTION

THIS COMMENT will discuss the federal income tax issue of unreasonable compensation as it affects the incorporated professional.¹ Discussion will first center on the *modus operandi* of the professional corporation, and how the compensation issue arises. Unreasonable compensation will then be defined and explained in that context. Next, the actual considerations used in determining whether compensation is excessive or not will be discussed. Then, the additional requirement that the remuneration be compensation in fact, and not a return on investment, will be investigated. The applicability of the 50% maximum tax on personal service income will also be analyzed. Finally, some conclusions will be drawn about the impact of these issues on the future of the incorporated professional.

I. THE PROFESSIONAL CORPORATION

Today, more and more people are noticing when it comes time to make out a check and pay their doctor bills that their physician seems to have changed his name, since the legend on their bill now reads "make checks payable to John Jones, M.D., Inc." Moreover, this phenomenon seems contagious and isn't limited to healers. Attorneys, architects, insurance agents, accountants and other professionals today are incorporating their practices. Since only the form of doing business has changed, operations go on as before, and the professional's daily routine hasn't changed much.

However, his legal status has been altered markedly. Some of the characteristics of the corporate form of doing business are perpetual existence, easy transferability of ownership interest, and limited liability. However, these are of little value to the professional since he is not usually interested in selling his practice to another, and what happens to it after he retires is likewise of little concern. Nor is his liability limited, since public policy dictates personal liability regardless.² The professional's interest is generally in the federal income tax advantage of a corporate pension plan. Ironically, though, under the corporate form there is the possibility that the professional may run into other unexpected adverse income tax consequences. These occur if the salary and other benefits the professional receives are deemed by the Internal Revenue Service to be excessive or unreasonable in amount. To better understand how a person can be penalized for making too much we must first examine the details

¹ See generally Stuetzer, *Reasonable Compensation*, 25 N.Y.U. TAX INST. 491 (1967); Comment, *The Worth of a Man: A Study of Reasonable Compensation in Close Corporations*, 38 S. CAL. L. REV. 269 (1965).

² Ohio so provides by statute. See OHIO REV. CODE ANN. § 1785.04 (Page 1978).

of how the incorporated professional has schemed to minimize his tax liability.

Generally, when a practice is incorporated the professional or professionals involved will become the sole stockholders of the corporation. Sometimes someone else will own a few shares of the corporation's stock, but the professional will be in control and practically all the profits will accrue to him. However, this is not the desired result. The federal government imposes a stiff corporate tax on the excess of corporate revenues over expenses.³ When these profits are paid out as dividends they are taxed again to their recipient under the personal income tax.⁴ Thus, corporate dividends are subject to double taxation. However, the incorporated professional has a way to avoid, or at least mitigate, this result. All businesses are allowed to reduce their gross income by their ordinary and necessary expenses,⁵ so the professional goes to work for his corporation, and as an employee draws a salary that is deductible⁶ the same as his secretary's or nurse's. Since today's professionals are generally highly compensated, their salaries tend to write the corporation's profits down to little or nothing. The problem arises when the corporation makes extremely high profits and the professional is forced to increase his salary to keep the excess profits from being subject to the corporate tax. Some unfortunate professionals run into this problem year after year. This is where the IRS steps in. It takes the position that since only ordinary and necessary expenses are deductible to the corporation, to the extent that the professional's compensation is excessive, it will be disallowed as a deduction,⁷ subjecting that amount to the corporate tax as well as the income tax.⁸ A corporation is allowed a deduction for only what a disinterested employer would have to pay a similarly qualified employee for doing the same type of work; the rest is deemed unreasonable. Thus the portion of compensation that exceeds what the professional would be paid in an arm's length situation will be subject to double taxation.

The courts have long recognized that the element of reasonableness is inherent in the phrase "ordinary and necessary."⁹ It is simply not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount.¹⁰ However, deductions for compensation usually are not questioned by the IRS

³ I.R.C. § 11.

⁴ *Id.* § 61.

⁵ *Id.* § 162(a).

⁶ *Id.*

⁷ Treas. Reg. § 1.162-7 (1960).

⁸ *Id.* § 1.162-8 (1960).

⁹ I.R.C. § 162(a).

¹⁰ *Comm'r v. Lincoln Elec. Co.*, 176 F.2d 815, 817 (6th Cir. 1949), *cert. denied*, 338 U.S. 949 (1950).

except in close corporations. This is because the opportunity to avoid taxes by arbitrarily overstating salary is so great in entities like the professional corporation. The controlling stockholder is free to set the amount of his compensation at will. In fact, so watchful is the IRS of this area that criminal prosecutions have been brought for willful tax evasion. Such a conviction can be based merely upon a compensation deduction which is unreasonable in amount, and is not limited to cases where a deduction was fraudulently claimed for services that were not rendered at all.¹¹

The IRS may disallow all or part of a claimed compensation deduction. This determination carries a presumption of correctness as to amount and the taxpayer has the burden of proving that his deduction, or any amount higher than that allowed by the Service, is reasonable.¹² Anyone familiar with the Internal Revenue Code knows this to be the general rule in tax contests not involving willful fraud. However, the courts are not bound by the Commissioner's estimate,¹³ and are not to be paralyzed by the complex or speculative nature of approximating the proper salary. The fact that valuation, being essentially a matter of informed judgment and experience, involves a rough estimate will not stop the courts from appraising the value of the individual's services.¹⁴ This sort of "blue penciling" by the courts is an application of the *Cohan* rule,¹⁵ which allows estimation of deductions necessitated by inadequate record keeping.¹⁶ Although the issue in most unreasonable compensation cases essentially involves valuation rather than records of the extent of services rendered, the principle is summed up well in *Rugel v. Commissioner*:¹⁷

A taxpayer always has the burden of establishing his right to any claimed deduction for income tax purposes. Where he seeks to have a deduction allowed by the Board of Tax Appeals [now the Tax Court], as an ordinary and necessary business expense . . . he must furnish as definite proof as is reasonably possible, in the situation and circumstances, of the nature and details of the expenditures claimed to have been made. If the evidence is convincing that the expenditures have thus been made, but the taxpayer is able to furnish only general proof of the nature and details, the Board should consider all the evidence in the light of its general experience and make such allowance for the sums expended as it conscientiously feels would represent fair and

¹¹ *United States v. Ragen*, 314 U.S. 513 (1942).

¹² [1980] 2 FED. TAXES (P-H) ¶ 11,612.

¹³ *See, e.g., Safe Deposit & Trust Co. of Baltimore v. Comm'r*, 35 B.T.A. 259 (1937), *aff'd*, 95 F.2d 806 (4th Cir. 1938).

¹⁴ *Helvering v. Safe Deposit & Trust Co. of Baltimore*, 316 U.S. 56 (1942).

¹⁵ *Cohan v. Comm'r*, 39 F.2d 540 (2d Cir. 1930).

¹⁶ *Id.* at 544. The *Cohan* rule was made inapplicable to travel, entertainment, amusement, or recreation expenses by the Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (codified at I.R.C. § 274(d)). For an example of the present application of *Cohan*, *see Levine v. Comm'r*, 324 F.2d 298 (3d Cir. 1963).

¹⁷ 127 F.2d 393 (8th Cir. 1942).

reasonable expenses for such ordinary and necessary purposes in the circumstances of the taxpayer's business.¹⁸

Keeping in mind that a disappointed taxpayer may with proper proof still salvage a compromise verdict in these cases, let us now examine the tests for determining reasonableness.

II. TESTS FOR DETERMINING REASONABLE COMPENSATION

A. *Actual Performance of the Services*

The first thing the IRS looks for whenever a business takes a deduction for employee compensation is whether the services were actually rendered.¹⁹ Although the amount of work performed is a question of fact, this test would seem to be less significant in scrutinizing the professional's salary in a professional, personal service corporation because it is solely from his labors that the corporation derives its revenues in the first place. All the revenues are directly traceable to the labor of the professional. He either produces billable hours or no fees are generated.

B. *Reasonableness of Amount*

The next item which the IRS questions in unreasonable compensation cases is the reasonableness of the amount itself.²⁰ One thing to remember is that we are talking about the reasonableness of the total compensation paid to the employee, not just one component. *Mayson Manufacturing Co. v. Commissioner*²¹ dismissed the argument that salaries, bonuses, and pension contributions could be examined and tested separately for reasonableness.²² Further, the inquiry is directed to individuals, not the collective salaries of all the employees. *L. Schepp Co. v. Commissioner*²³ rejected the contention that reasonableness could refer to the whole wage policy of the employer. The fact that a company's total wage policy is reasonable is no defense to the fact that one or more employees are excessively compensated.²⁴

The determination of the issue of reasonableness lies solely in the surrounding circumstances of each case²⁵ and is therefore strictly a question of fact for the jury. However, it has been suggested that judges are more favorable to taxpayers as triers of fact. Jurors apparently tend to take with a grain of salt being told that someone making more money than all of

¹⁸ *Id.* at 395.

¹⁹ 11 FED. TAX COORD. 2d ¶ H-2606.1 (May, 1978).

²⁰ *Id.*

²¹ 178 F.2d 115 (6th Cir. 1949).

²² *Id.* at 119.

²³ 25 B.T.A. 419 (1932).

²⁴ *Id.* at 429.

²⁵ *First Trust & Sav. Bank, Merville, Iowa v. United States*, 67-1 U.S.T.C. (CCH) ¶ 9233 (N.D. Iowa, Dec. 9, 1966).

them put together is not excessively compensated.²⁶ Nevertheless, the courts of appeal may not overturn this fact finding unless it is clearly erroneous.²⁷

Numerous factors have been delineated by courts as relevant to the issue of reasonableness. None is conclusive, but each is to be examined separately and its value as evidence considered.²⁸

One of the most obvious tests would be that of the prevailing rate of compensation for comparable services in comparable business concerns.²⁹ If three attorneys incorporated together and the compensation paid one of them is in issue, the salaries in question are those paid by law firms of the same general size, not firms with one hundred members. Nor would one look to the legal department of an insurance company or a rubber manufacturer. Further, if the attorney was doing work in poverty law, the salaries paid to patent attorneys would not be relevant to the issue. This comparison can be made even if other firms' employees are not as qualified as the taxpayer's. It is especially helpful if a competitor pays less skilled employees as much as the taxpayer pays his.³⁰ The desired inference here is that since competitors pay a like amount for the same work, the taxpayer is not exceeding what the market dictates. For example, in a case involving boxer Jack Dempsey, comparison was allowed between the amounts paid him for the use of his name and services by the taxpayer, and by his other employers. His compensation from the taxpayer being not disproportionately greater than what others paid, the taxpayer's deduction was sustained.³¹ One court has even allowed evidence of higher salary offers from competitors to be used to rebut the Commissioner's determination of unreasonableness. This was allowed even though the taxpayer's officer was already the most highly compensated executive in the industry.³²

Common sense tells us that the individual's qualifications are also important.³³ The more education and experience a person has, the more it would be reasonable to pay him. His rate of compensation can be compared to those drawn by others with equal talents. Furthermore, an extremely high salary can sometimes be justified on the basis that the person is a stand-out in his field. This is the part of an individual's qualifications

²⁶ J. FREELAND, FEDERAL INCOME TAX TAPE, Tape 2, Side 4 (1975).

²⁷ *Comm'r v. Duberstein*, 363 U.S. 278, 291 (1960).

²⁸ See *First Trust & Sav. Bank, Menville, Iowa v. United States*, 67-1 U.S.T.C. (CCH) ¶ 9233 (N.D. Iowa, Dec. 9, 1966). For an article illustrating the factual inquiries which are made in such cases, see generally Rogers, "Reasonable Compensation," *Deductibility for Income Tax Purposes: Three Case Studies*, 10 WM. & MARY L. REV. 118 (1968).

²⁹ *Mayson Mfg. Co. v. Comm'r*, 178 F.2d at 119. But see *Perlmutter v. Comm'r*, 373 F.2d 45 (10th Cir. 1967), discussed at note 52 *infra*, which suggests that comparability alone is not sufficient to establish reasonableness, at least where other negative factors are present.

³⁰ *Multi-Lead Tool & Eng'r Co.*, 20 T.C.M. (P-H) ¶ 51,050 at 161-62 (Feb. 28, 1951).

³¹ *Jack Dempsey's Punchbowl, Inc. v. Comm'r*, 11 T.C. 1030 (1948).

³² *Pfeiffer Brewing Co.*, 21 T.C.M. (P-H) ¶ 52,179 (June 12, 1952).

³³ *Mayson Mfg. Co. v. Comm'r*, 178 F.2d at 119.

that his resume cannot capture. There are many professionals who are renowned beyond all others in their field. Astronomical amounts can be considered reasonable if a professional's peers consider him to be one of the leading experts in his area. This was the case in *Eduardo Catalano, Inc.*,³⁴ which involved a former professor of architecture at one of America's leading universities. Before Catalano left to form a one-man consulting firm for the avowed reason of limiting his professional liability, he had become one of the most distinguished men in his area of architecture. Within a few years after his corporation began operations he was able to make yearly contributions to his pension fund of such large amounts that if the contributions alone had been his only compensation, the reasonableness issue might have been raised.³⁵ Despite some facts that raised the question of whether Catalano was just trying to avoid double taxation by increasing his remuneration, the Tax Court, in light of his extraordinary qualifications, found his total compensation to be reasonable.³⁶ There is no reason this line of thinking can't be extended to somewhat lesser mortals. It would seem that even if our professional isn't the leading person in his field, to the extent that he has acquired a valuable reputation, it would not be unreasonable for him to demand a premium from his employer.

The courts have also paid deference to individuals with a special knowledge or experience for their particular duties or their employer's field of business.³⁷ One such case involved a diamond appraiser whose skill and trustworthiness were of paramount importance to his employer.³⁸ This principle would seem applicable to not only the jeweler who incorporates, but the heart surgeon as well. The courts will also consider experience acquired in the taxpayer's service.³⁹ This would seem favorable to the professional, since he ought to be able to count experience acquired since the day he went into practice, whether incorporated or not. The point is that the professional knows how to deal with his employer's particular needs. Rounding out the individual's qualifications is the possibility of an innate technical or inventive ability. If the employee is particularly gifted in his area⁴⁰ or is adroit at designing, perfecting, or maintaining the company's operations,⁴¹ the courts will take this as evidence of reasonableness.

There are other factors, such as those dealing with the business of the employer or the job itself, that bear on the issue of reasonableness and do not involve the individual. For example, it has previously been seen that

³⁴ [1979] TAX CT. MEM. DEC. (P-H) ¶ 79,183 (May 9, 1979).

³⁵ *Id.* at 726.

³⁶ *Id.* at 729.

³⁷ Appeal of A.R. Swartz & Co., 5 B.T.A. 264 (1926).

³⁸ Wm. Rubin & Son, Inc., 16 T.C.M. (P-H) ¶ 47,068 (Mar. 20, 1947).

³⁹ Hawaiian Freight Forwarders, Ltd., 16 T.C.M. (P-H) ¶ 47,149 (May 29, 1947).

⁴⁰ General Brass & Machine Works, Inc., 14 T.C.M. (P-H) ¶ 45,308 (Oct. 12, 1945).

⁴¹ Soabar Co. v. Comm'r, 7 T.C. 89 (1946).

the type of work the professional does is one factor to be checked,⁴² but here the actual quality of the work performed by the professional is examined.⁴³ Just how well does he actually do the work performed? Also, remembering that performance in the business world is judged by the fruits one produces, the results of the professional's labors are paramount.⁴⁴ Two individuals can both be doing an equally expert job in their respective areas, but if the labors of one produce more profit for the company, there is little doubt who is more valuable. In *Charles McCandless Tile Service v. United States*,⁴⁵ father and son ceramic contractors were the sole shareholders of their business. The court found the compensation was reasonable, since the two employees played a critical role in the corporation's unusually successful and profitable operations.⁴⁶ In addition, if the employee's duties are of a type not normally required of such employment, or the company's services are unusual in the sense of being new or not generally performed in the industry, the courts can take such evidence as justifying higher compensation.⁴⁷

A personal service corporation isn't necessarily limited to just a few employees. How well those in charge wield the employees beneath them can be just as important as how they handle and satisfy the customers. Just because capital isn't a material income-producing factor in professional corporations, that doesn't mean that there can't be a number of employees under the control of the professional. This would be so, for instance, in an engineering firm and comes under the recognized category of technical managerial ability.⁴⁸ A related heading the courts have approved is that of general managerial ability. Here an employee receives credit for his abilities in formulating and administering the successful operation and policies of the business.⁴⁹ The size of the enterprise is important, since the greater the size and complexity of the business, the more evidence there is of reasonableness.⁵⁰ For example, few would question that the work of a surgeon is more complex than that of a plumber.

Also, the bigger the operations and volume of business are, the higher compensation can be without becoming a larger percentage of total revenues.⁵¹ As the business becomes more profitable, the person responsible deserves greater compensation. In short, the better the general economic con-

⁴² See text following note 29 *supra*.

⁴³ *Mayson Mfg. Co. v. Comm'r* 178 F.2d at 119.

⁴⁴ *Id.*

⁴⁵ 422 F.2d 1336 (Ct. Cl. 1970).

⁴⁶ *Id.* at 1340.

⁴⁷ *Insul-Mastic Corp. of America*, 19 T.C.M. (P-H) ¶ 50,167 (June 30, 1950).

⁴⁸ *Eitel-McCullough, Inc. v. Comm'r*, 9 T.C. 1132 (1947).

⁴⁹ *H.V. Greene Co. v. Comm'r*, 5 B.T.A. 442 (1926).

⁵⁰ *Mayson Mfg. Co. v. Comm'r*, 178 F.2d at 119.

⁵¹ *Id.*

ditions of the business are, the better the position of the taxpayer is. This kind of rationale is used in justifying contingent compensation agreements, reasonable when entered into, which become unreasonable bonanzas for the employee when business later booms. *Perlmutter v. Commissioner*⁵² seems to take the position that if compensation is increased disproportionately to what the Service feels is an unreasonable amount, the fact that other businesses in the same line pay like salaries cannot be relied upon. Rather, additional concrete evidence should be introduced to justify the increase.⁵³ For example, a significant expansion of operations or increase in profits would seem to be the palpable kind of evidence necessary for the taxpayer to carry his burden of proof.⁵⁴

In addition, if the responsibility for such increments, or even the general success or profits themselves, are attributable to the employer's officer, then there is strong evidence of reasonableness. If it can be shown that the employee is responsible for building up the business and is chiefly responsible for its growth, the Commissioner's position is weakened.⁵⁵ This would seem to be especially applicable to the professional corporation since its success and viability depends almost wholly on the dominant professional.

Increased business activities can also lead to greater employee duties. *Pacific Grains, Inc.*⁵⁶ is based on the premise that increasing responsibility or workload is an indication of reasonableness. In that case the court held that where large, unexplained increases and bonuses had occurred near the end of the tax year, there could be no deduction since there was no evidence of an increase in the taxpayer's duties.⁵⁷ Also, additional services, in the sense of duties beyond those normally expected in the firm or industry, can stand to rebut the charge of unreasonableness.⁵⁸

This brings us to an examination of the actual process by which the employee's compensation comes to be determined, and how this internal corporate process bears on the reasonableness of the benefits. In any un-

⁵² 373 F.2d 45 (10th Cir. 1967).

⁵³ Compare *Perlmutter with Mayson Mfg. Co. v. Comm'r*, 178 F.2d 115 (6th Cir. 1949) and *Jack Dempsey's Punchbowl, Inc. v. Comm'r*, 11 T.C. 1030 (1948), discussed at note 31 *supra*, which held that compensation which was comparable to that paid by other businesses in the field was reasonable. The apparent contradiction is explained by the presence of other factors in *Perlmutter*, i.e., the officer's salary was greatly increased at a time when no dividends were paid, and the corporation's gross and net income and the officer's own activities had all decreased. The *Perlmutter* court weighed these factors against the comparability of salaries, 373 F.2d at 48, and concluded that the shareholder-officer was not entitled to a deduction.

⁵⁴ See 373 F.2d at 48.

⁵⁵ *Good Chevrolet*, 46 T.C.M. (P-H) ¶ 77,291 (Aug. 30, 1977).

⁵⁶ 36 T.C.M. (P-H) ¶ 67,007 (Jan. 13, 1967), *aff'd on other grounds*, 399 F.2d 603 (9th Cir. 1968).

⁵⁷ 36 T.C.M. (P-H) at 55. See also text following note 81 *infra*.

⁵⁸ *Merchandise Terminal Warehouse, Inc.*, 11 T.C.M. (P-H) ¶ 42,514 (Sept. 21, 1942). See text accompanying note 47 *supra*.

reasonable compensation proceeding, the corporation will strengthen its case by showing that the actions of its board of directors were taken without any undue influence from the employee. However, in the setting of the professional corporation, for all practical purposes the professional is the board of directors. Generally, his decision making power is unrestrained. This is evident in *Perlmutter*, where the court held that total control of the company by the employee and his informal practice of making salary withdrawals were factors to be used in discounting the claim of reasonableness.⁵⁹ Although a professional's practice of constantly changing his own salary and awarding himself bonuses bears on the question of compensation in fact,⁶⁰ it also reflects on reasonableness. This is because it tends to indicate a lack of real bargaining in the wage determining process. In essence, the professional merely takes whatever he wants, subject only to availability. Since there is no independent party guarding the till, it becomes his personal expense account which he may raid at will.

However, these compensation increments can easily be justified by a change in economic conditions. If a corporate officer was either under-compensated or received no salary during the formative years of the business, or during financial hard times, this can be a justification for changing salaries.⁶¹ This is because the services compensated for needn't be performed in the taxable year. If they were actually rendered in prior years but were never compensated, the unreasonableness charge can be discounted by showing that part of the present salary is for those past services.⁶² This common practice of the officers or owners of close corporations taking pay cuts in times of financial stress⁶³ seems analogous to the professional situation of the lean, clientele-building years. Also, a tradition of modest raises or bonuses in the past can be used to refute the claim that raises or year end payments are motivated by tax avoidance.⁶⁴

Finally, there are a few miscellaneous salary comparisons that can be made to shed light on the reasonableness issue. One is the ratio of the professional's total compensation to the corporation's net and gross incomes.⁶⁵ Although this may bear also on the compensation in fact issue, it relates to the reasonableness issue in that, generally speaking, businesses don't pay out all or almost all of their revenues to a single individual, nor do they pay out all or almost all of their profits to even the most valuable employee.⁶⁶ Outside of the professional corporation, one of the areas

⁵⁹ 373 F.2d at 48.

⁶⁰ See text following note 71 *infra*.

⁶¹ *Marshall & Spencer Co. v. Comm'r*, 7 B.T.A. 454 (1927).

⁶² *Id.*

⁶³ See *Universal Steel Co. v. Comm'r*, 5 T.C. 627 (1945).

⁶⁴ *Appeal of Max Levy & Co.*, 3 B.T.A. 422 (1926).

⁶⁵ *Mayson Mfg. Co. v. Comm'r*, 178 F.2d at 119.

⁶⁶ See, e.g., *Atlas Plaster and Fuel Co. v. Comm'r*, 55 F.2d 802 (6th Cir. 1932).

of concern is the relationship between stockholdings and compensation, but in a professional corporation this is the basic problem. There will naturally be a relationship, since the professional or professionals will own the corporation almost entirely. In a one-man firm the relationship will be absolute, but with two or more people there will be room to make valuable comparisons. If the two professionals have equal stockholdings but different compensation, and the compensation of the one paid the most is questioned, the corporation can defend by showing that it pays the more qualified person a higher salary and thereby rebut the inference that the two simply take their compensation in partnership-like agreement. Why would one stockholder let another take a larger share of the profits if he weren't worth it? Nevertheless, it is still wise to try to show that the higher paid individual does more work or actually is more experienced.⁶⁷ This is especially important where there are unequal stockholdings and the greater shareholder also receives more pay.⁶⁸

However, the fact that professionals in such corporations are shareholders makes less useful another analysis that courts have recommended. This is the comparison of the professional's salary to those of other employees.⁶⁹ In another setting this would tend to reveal any deviation from the corporation's general salary policy, but in the professional corporation all the professionals could conspire to pay each other a portion of their respective share of the profits in the form of salaries. Another difficulty is the fact that there will probably be only a few people in such corporations available for comparison. This is because of the generally small size of professional corporations, and the non-professional status of other employees. In other words, there is only a small number of peers to compare the professional to, and most of the other employees make poor comparisons.

C. *Compensation in Fact*

Even if all these factors are examined and weighed, and the determination is that the amount is reasonable, there is still one more requirement which the IRS can employ to win. This additional requirement, beyond actual performance of the services⁷⁰ and reasonableness in amount,⁷¹ is that of compensation in fact. In other words, salary received must be both "reasonable in amount and compensatory in character."⁷² What this means is that if part of the salary paid is actually a dividend, the deduction is disallowed for that amount and it is subject to double taxation.⁷³ What we

⁶⁷ Appeal of Woodcliff Silk Mills, 1 B.T.A. 715, 718 (1925).

⁶⁸ See, e.g., Twin City Tile and Marble Co. v. Comm'r, 32 F.2d 229 (8th Cir. 1929).

⁶⁹ Mayson Mfg. Co. v. Comm'r, 178 F.2d at 119.

⁷⁰ See text following note 19 *supra*.

⁷¹ See text following note 20 *supra*.

⁷² Eduardo Catalano, Inc., [1979] TAX CT. MEM. DEC. (P-H) at 728.

⁷³ This is because corporations may deduct expenses, I.R.C. § 162(a), but not dividends for shareholders, see Treas. Reg. § 1.162-7(b)(1) (1960). At the same time, dividends are taxable to the recipient, I.R.C. § 61.

are concerned with here is the fact that if all the capital in the professional corporation had been put up by a separate entrepreneur he would probably expect some return on his investment and any working capital retained. Corporations pay dividends, and if a professional corporation doesn't, it will raise not only the compensation in fact issue, but reasonableness as well.

Earlier, mention was made of the *McCandless*⁷⁴ case, where the compensation had been held to be reasonable in amount. Not mentioned was the fact that the IRS won that case. In *McCandless*, where no dividends had ever been paid, the court computed a return on capital based on 15% of net profits before salaries, and deemed that portion of the salaries a non-deductible dividend.⁷⁵ Although this approach seems contrary to statutory language,⁷⁶ it is sanctioned by the regulations⁷⁷ and followed by both the IRS and the courts. As the court put it:

We think it clear that any return on equity capital is so conspicuous by its absence as to indicate, given all the facts, that the purported compensation payments necessarily contained a distribution of corporate earnings [A] corporation's highly efficient operation and its clearly demonstrated profit-making ability justifies a substantial investment return.⁷⁸

This is not to say that the absence of dividends is conclusive. The court in *Nor-Cal Adjusters*⁷⁹ specifically stated that it is not, but went on to say that a profitable corporation with the ability to pay has the great burden of explaining its poor or non-existent dividend record.⁸⁰

Sometimes the method by which the salaries are determined will shed light on the dividend issue. The aforementioned practice of increasing compensation with unexplained bonuses and raises⁸¹ tends to hint at the existence of disguised dividends. *National Underwriters, Inc.*⁸² is illustrative. In that case, insurance agents estimated profits each month and paid them out in the form of bonuses, successfully writing corporate profits down to zero. The Tax Court had little difficulty in such an extreme case.⁸³ Nevertheless, changing salaries and granting bonuses at special board meetings is evidence against the corporation.

The type of compensation arrangement can also be revealing. For

⁷⁴ 422 F.2d at 1336. See text following note 45 *supra*.

⁷⁵ *Id.* at 1340.

⁷⁶ I.R.C. § 162(a) permits "a reasonable allowance for salaries or other compensation for personal services actually rendered[.]"

⁷⁷ See Treas. Reg. § 1.162-7(b)(1) (1960).

⁷⁸ 422 F.2d at 1339-40.

⁷⁹ 40 T.C.M. (P-H) ¶ 71,200 (Aug. 16, 1971).

⁸⁰ *Id.* at 882.

⁸¹ See text at note 57 *supra*.

⁸² 43 T.C.M. (P-H) ¶ 74,014 (Jan. 23, 1974).

⁸³ *Id.* at 57.

example, in *Klamath Medical Service Bureau v. Commissioner*⁸⁴ a group of doctors formed a medical corporation and contracted themselves out to it on the basis of a fee schedule. This type of arrangement was less blatant than a percentage-of-profits contract, which would have been set so close to 100% of the profits in order to achieve the desired result that it would clearly have shown the parties' intentions of disguising dividends. Accordingly, the doctors based their pay scale on a fee schedule fairly representative of that charged by other physicians. This arrangement would have been successful if the company had not continued to show profits above the amounts paid the doctors under their contract. These profits were paid out in bonuses and were disallowed by the Tax Court, which reasoned that the doctors already had an arrangement that would compensate them according to their performances; there was no business reason to reward them with further bonuses.⁸⁵

Courts speak of payment in good faith⁸⁶ in these agreements, and being generally accustomed to dealing with sales commission contracts calling for under 5% of gross sales, they are not likely to validate contracts aimed at wiping out corporate profits.⁸⁷

The exact treatment of disallowed amounts remains to be considered. We have already said that disallowance of a deduction means that such amounts will be subject to the corporate income tax, assuming that previously the corporation was at least breaking even. We then said that double taxation occurred, as the recipient was taxed regardless of disallowance, assuming no agreement to repay in such an event.⁸⁸ Because of the professional's stockholder relationship to the corporation, any disallowed amount will be treated as dividends. This is the concept of constructive dividends; no formal corporate declaration is necessary.⁸⁹ However, disallowed dividends are not only ordinary income, i.e., non-capital gains, they are also passive income, and therefore not eligible for the 50% maximum tax rate on earned income.⁹⁰ This is because the Code states that earned income "does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance for

⁸⁴ 29 T.C. 339 (1957).

⁸⁵ *Id.* at 343.

⁸⁶ [1980] 2 FED. TAXES (P-H) ¶ 11,692(5).

⁸⁷ *R.H. Oswald Co. v. Comm'r*, 185 F.2d 6 (7th Cir. 1950).

⁸⁸ *See* note 73 *supra*. An agreement to repay would give the professional a deduction, while the rebate would not be income to the corporation. *Blanton v. Comm'r*, 46 T.C. 527 (1966).

⁸⁹ *Doughboy Indus., Inc. v. United States*, 4 A.F.T.R.2d ¶ 59-5009 (W.D. Wis. May 14, 1959).

In a family corporation, such amounts might be treated as non-taxable gifts. *See Comm'r v. Duberstein*, 363 U.S. 278, 294 (1960) (Frankfurter, J., concurring in the judgment); *Smith v. Manning*, 189 F.2d 345 (3d Cir. 1951). If considered as part payment for property, compensation can be treated as capital gains. *Treas. Reg.* § 1.162-8 (1960).

⁹⁰ *See* I.R.C. § 1348.

compensation for the personal services actually rendered.”⁹¹ Since the type of individual whose compensation might be questioned as unreasonable could well have total income exceeding the 50% bracket, the constructive dividend could easily be taxed at greater than the 50% limit applicable to the rest of the professional’s salary and bonuses.

CONCLUSION

The success of professional corporations rests on the performance and foresight of those in charge. Their profitability stems largely from labor and not capital and it is only fair that the rewards of a labor-intensive operation should go to the laborer responsible. Nevertheless, a corporation can’t, year after year, pay out all, or almost all, of its profits as compensation to the shareholder-employee. Even though the profits stem from the employee’s personal efforts, they belong to the corporation and not the professional. This is the price of using the corporate form. However, the liberal attitude taken by the courts and the recent reduction of the corporate tax rate to 17% for the first \$25,000 of profits⁹² would seem to mitigate the problem sufficiently that the benefits still outweigh the costs.

VINCENT J. FALCONE

⁹¹ *Id.* § 911(b).

⁹² I.R.C. § 11(b)(1).