Navigating Tax Risks In Shareholder-Executive Compensation

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In recent years, the Internal Revenue Service has focused on compensation paid to executives who are shareholders in business enterprises, to ensure compliance with employment and income tax requirements. These steps are part of the IRS' goal to improve tax compliance by corporations and high-income taxpayers. C corporations and S corporations are among the most heavily scrutinized entities.

The IRS requires that both C and S corporations compensate executive-shareholders based on the fair market value of the services rendered. Companies that do not take the appropriate steps to justify compensation paid face the risk that, upon being audited by the IRS, they possibly will be penalized by the IRS' hefty accuracy-related fine. Under Treasury Regulation Section 6662, the IRS may impose an accuracy-related penalty equal to 20 percent of underpayment of federal tax resulting from certain specified taxpayer behaviors such as negligence, disregard of rules or regulations, substantial understatement of income tax, and certain valuation misstatements.

This article presents some of the executive-shareholder compensation pitfalls that companies and their legal counsel may experience in disputes with the IRS, as well as federal income tax statutes and judicial precedents related to this issue.

Legislative and Judicial Guidance

To determine the reasonableness of executive-shareholder compensation, experts should consider both statutory authority and judicial guidance. Internal Revenue Code Section 162(a) provides that executive-shareholder compensation is deductible as a business expense if it is reasonable in amount and based on the services rendered. For executive-shareholder compensation to qualify as reasonable employee compensation, Treasury Regulation 1.162.7 provides that executive-shareholder compensation for personal services should be an ordinary and necessary expense, paid or incurred by the corporation in connection with carrying on any trade or business, be reasonable in amount and based on personal services rendered. Companies and their corporate counsel are advised to support compensation paid to executive-shareholders by carefully documenting each executive's qualifications, duties and key accomplishments.

Judicial precedent provides guidance related to the factors that experts should consider when preparing reasonableness of compensation analyses. The Court of Appeals for the Sixth District originally provided eight factors that should be evaluated in determining the reasonableness of compensation paid to an executive-shareholder in Mayson Manufacturing Company v. Commissioner.[1] In 1996, the Tax Court expanded the Mayson factors in Pulsar Components International Inc. v. Commissioner[2] to include considerations such as the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexity of the business; a comparison of salaries against

the company's gross and net income; the general economic conditions and the expected performance of the industry; a comparison of salaries against distributions to officers, retained earnings and the employer's dividend history; the rates of compensation for comparable positions in comparable companies; the salary policy of the employer as to all employees; the amount of compensation paid to the employee in previous years; and whether the employer and employee dealt at arm's length.

In Trucks Inc. v. U.S.,[3] members of the Hilt family and a family-owned corporation, Hilt Truck Lines Inc., or HTL, instituted tax refund suits as civil actions for the recovery of corporate and individual Internal Revenue taxes paid by them and claimed to have been wrongfully assessed and collected by the IRS.

In this matter, the taxpayers' expert conducted an exhaustive study of the Hilt family-owned corporations which established that the salaries paid to HTL's officer and supervisory team (the Hilts) were at, near or below the low end of the spectrum for the comparable entities. Among other analyses, the expert provided comparisons of the subject company with prevailing rates of compensation for various other truck lines. The expert compared the amount of compensation paid to the Hilts with HTL's gross freight revenue, operating income and net income (before salaries) produced. He then did similar comparisons for selected comparable companies in the industry. When he compared the amounts of earnings which HTL allocated to the payment of executive compensation with corresponding information of the other companies, he demonstrated that HTL was not paying excessive executive compensation, and, importantly, the Tax Court agreed, and the Hilt family prevailed.

The Independent Investor Test

The federal courts have also relied on the independent investor test in reasonable compensation disputes. The independent investor test is premised on the presumption that an employee's compensation is reasonable if investors obtain a far higher return than they had any reason to expect. The rationale behind the independent investor test is that investors pay employees to perform work that increases the value of the assets entrusted to their management. This independent investor test was first set out in Elliotts Inc. v. Commissioner.[4][5] A high rate of return indicates that the assets value increased and that the employee provided valuable services. Thus, if investors obtain returns exceeding what they should reasonably expect, an employee's salary is presumptively reasonable. The presumption is rebutted if the high rate of return is attributable to an extraneous event rather than the manager's efforts.[6]

In applying the independent investor test, the total return to the investor is considered, including dividends, stock appreciation and corporate earnings. In Beiner Inc. v. C.I.R.[7], the Tax Court considered five factors from the perspective of a hypothetical, but passive, independent investor. In Beiner the Tax Court reached a conclusion with respect to the reasonableness of the executive-shareholder compensation paid to Robert Beiner in 1999 and 2000. In determining the amount of executive-shareholder compensation that was reasonable and, therefore, deductible as a business expense, the Tax Court relied on the opinion of the taxpayer's expert. That expert testimony was based on compensation data extracted from 34 publicly held companies in similar industries. The Tax Court based its independent investor consideration on the actual rate of return on owner's equity for the

subject company — compared to a market-derived required rate of return on owner's equity.

In contrast, in Brinks Gilson & Lione (BGL) v. Commissioner[8], the Tax Court applied the independent investor test to examine the reasonableness of compensation paid in the form of year-end bonuses to attorney shareholders, which reduced the company's reported income to zero. The Tax Court disallowed a portion of the disputed compensation and imposed an accuracy-related penalty related to the underpayment of income taxes resulting from the overpayment of compensation.

The Tax Court noted in BGL that it was the intent of the company that the sum of the bonuses reduced book income to zero. Further, notwithstanding the fact that attorney shareholders were entitled to receive dividends, for at least the 10 years preceding the years at issue, BGL had not paid any dividends. Upon a review of the BGL 2007 and 2008 income tax returns, the IRS disallowed various BGL expense deductions, including the year-end bonuses paid.

Advocate Versus Independent Expert

Transupport Inc. v. Commissioner[9] demonstrates the importance of utilizing an independent expert who employs objective, data-driven, and legislative- and judicial precedent-supported analysis in reasonable compensation determinations. In this matter, the Tax Court rejected the testimony of the taxpayer's expert on the reasonableness of compensation paid to four shareholder-employees who were the sons of the controlling shareholder of the company. The court found that the expert's analysis utilized an approach that served merely to support the company's compensation claims, instead of presenting relevant facts in an independent and objective analysis. The Tax Court concluded that salaries paid from 2006 to 2008 to four executive-shareholders were unreasonably excessive. Annual pay for the sons were determined without consulting any other party, causing the Tax Court to determine that the controlling shareholder was motivated by the reduction of reported taxable income, equal treatment of each son, and percentage ownership of the company's stock, and not the value of services rendered by the sons.

Further, the Tax Court determined that the sons had no special experience or education to qualify them for their positions. The Tax Court rejected the taxpayer's compensation expert because the expert, among other errors, failed to consider evidence that contradicted the reasonableness of the sons' compensation, including evidence that the sons lacked the basic knowledge needed to perform their jobs. In fact, the Tax Court noted that the sons repeatedly displayed professional ignorance on business matters that were allegedly under their respective purview within the company. The expert's work was also criticized for disregarding sources and criteria that the expert used in other cases that would have indicated lower reasonable compensation amounts, and for assuming that the company, which was in fact a wholesaler, was a manufacturer rather than a wholesaler, when selecting data from the compensation database.

S Corporations Versus C Corporations

With regards to executive-shareholder compensation, if the subject company is structured as an S corporation, it may be motivated to pay an executive-shareholder little or no income in the form of a salary. An executive-shareholder of an S corporation may instead receive

compensation in the form of income distributions. By structuring compensation in this manner, the shareholder may avoid various employment taxes typically applicable to a salary. Therefore, S corporations are more likely to undercompensate executive-shareholders because compensation is subject to federal and state payroll taxes, which the company and shareholders would prefer to avoid, while dividends and distributions are not subject to such taxes. As an example, in David E. Watson PC, v. United States of America,[10] Watson, a CPA, gave himself a $24,000 salary and approximately $204,000 in dividends. Watson did not provide a supportable reasonable compensation analysis for the $24,000 salary. In fact, the IRS showed that even a beginning accountant would make more than $24,000 and a typical accountant of Watson's experience would bring in a salary of about $90,000. This case exemplifies the IRS' right to recharacterize some distributions as wages if a supportable reasonable compensation figure is not determined and documented by the company.

When the subject company is structured as a C corporation, an executive-shareholder may receive compensation in the form of a salary above and beyond market-based indications. The executive-shareholder of a C corporation would be inspired to take a greater portion of compensation as salary because such payments are tax-deductible expenses for a C corporation, whereas dividends paid to shareholders are not deductible for federal income taxes purposes, thereby incentivizing the company to overcompensate its executive-shareholders. By taking compensation as a salary, in lieu of dividends, an executive-shareholder may avoid the indirect cost of higher corporate taxes.

Conclusion

Due to the significant amount of tax revenues involved, executive-shareholder compensation of both C and S corporations has been closely scrutinized by the IRS and by the Tax Court. Many disputes have resulted in litigation, which is costly and distracting even if ultimately successful for the taxpayer. Reasonable compensation should be determined based on the fair market value of the services rendered, and because determining reasonable executive-shareholder compensation can be a challenging task, the retention of an independent expert is often warranted.

Companies and their corporate counsel that don't take steps to ensure that executive-shareholder compensation is based on the fair market value of the services rendered face the risk of being audited, and, incurring substantial accuracy-related penalties. The judicial decisions summarized above, specifically, those in which the Tax Court did not make determinations in favor or the company's compensation claims, demonstrate the importance of retaining a qualified, independent expert to prepare analyses of reasonable compensation. This will be the best defense against successful assertions of abuse of the fair compensation deduction requirements.

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[1] Mayson Manufacturing Co. v. Commissioner, 178 F.2d 115 (6th Circuit. November 17, 1949)

[2] Pulsar Components International Inc. v. Commissioner, T.C. Memo. 1996-129 (March 14, 1996)

[3] Trucks Inc. v. U.S., 588 F. Supp. 638 (D.C. Neb. April 3, 1984)

[4] Elliotts Inc. v. Commissioner, 716 F.2d 1241, 1243 (9th Cir.1983)

[5] Elliotts Inc. v. Commissioner, T.C. Memo. 1984-516 (Sept. 27, 1984)

[6] Mulcahy, Pauritsch, Salvador & Co. Ltd. v. Commissioner, T.C. Memo. 2011-74 (March 31, 2011)

[7] Beiner Inc. v. C.I.R., T.C. Memo 2004-219 (September 28,2004)

[8] Brinks Gilson & Lione a Professional Corporation v. Commissioner, T.C. Memo. 2016-20 (February 10, 2016)

[9] Transupport Incorporated v. Commissioner, T.C. Memo. 2016-216 (November 23, 2016)

[10] David E. Watson PC v. United States, 757 F. Supp. 2d 877 (S.D. Iowa 2010)