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THE DEDUCTIBILITY OF REASONABLE COMPENSATION IN THE CLOSE CORPORATION

Edward M. Alvarez*  

Section 162 of the Internal Revenue Code provides that a taxpayer may deduct all ordinary and necessary business expenses including "a reasonable allowance for salaries or other compensation for personal services actually rendered." The code provision permitting a deduction for reasonable salaries or other compensation for personal services has formed a part of the taxing statutes since 1916. Although there has been some dispute as to the legislative purpose of Section 162, it seems clear that the Section was intended to permit a limitation on the compensation of employees who are also stockholders to only that compensation which is reasonable in light of the circumstances. Since 1916, litigation has been so plentiful that statistical summaries have been prepared analyzing decided cases in an attempt to assist tax planners in evaluating a specific factual situation. These summaries include no less than 500 reported cases.

The great majority of the cases in this field involve close corporations. In most cases the employees whose salaries are in

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1 INT. REV. CODE of 1954, § 162(a)(1), as amended.
2 Revenue Act of 1918, §§ 214(a)(1), 234(a)(1).
3 59 HARV. L. REV. 286 (1945).
4 See Revenue Act of 1916, Reg. 33 (revised), Art. 138, which provides:
"Salaries of officers or employees who are stockholders will be subject to careful analysis, and if they are found to be out of proportion to the volume of business transacted, or excessive when compared with the salaries of like officers or employees of other corporations doing a similar kind or volume of business, the amount so paid in excess of reasonable compensation for the services will not be deductible from gross income, but will be treated as a distribution of profits."

6 A close corporation is defined for purposes of this article as a corporation
question are also shareholders of the corporation or members of a family controlling the corporation. Until recently, the typical reasonable compensation case could be characterized as involving a basic factual inquiry as to whether or not the questioned salary was unreasonably high when measured against the judicial standards developed over the years. This article is not intended to be a review of the decided cases or a review of all of the facets of reasonable compensation decisions. Its purpose is to examine recent cases in order to demonstrate that previously developed judicial criteria for deciding the “reasonableness” of compensation in corporations may no longer be germane to the resolution of such cases.

**General Principles**

The problem at hand can be simply stated. Although a corporation is entitled to deduct a reasonable amount for compensation paid for personal services, in any close corporation the amount of the deduction will come under close scrutiny in an effort to determine whether or not the amount paid is purely for personal services or is in reality a distribution of corporate earnings otherwise taxable as a dividend. To the extent that earnings can be distributed by a corporation to its shareholders without incurring a corporate tax on those earnings, an overall tax benefit will result. Since corporate earnings are taxed at 48 per cent above $25,000 of taxable income, each dollar paid to a shareholder-employee which is deductible as compensation will usually result in an over-all tax savings of $.48. The only alternative available for distributions of earnings to a shareholder is a dividend which is not deductible by the corporation. Thus, it is apparent that the question of reasonableness of compensation is inseparably related to the question of whether or not all or a portion of the purported compensation payment is in reality a disguised dividend.

A reasonable compensation case usually involves two basic issues. First is the question of whether the payment was in fact made for services actually rendered. The problem here is determining the intent of the parties. Was the distribution of compensation intended to be a distribution of earnings and not the purchase price which has relatively few shareholders. See Oneal, Close Corporations, Vol. 1, § 1.02 (1958).

9 INT. REV. CODE of 1954, § 11.
10 See generally INT. REV. CODE of 1954, § 316.
for services? Second is the question of whether the amount of the payment is reasonable in light of the services performed. Here the nature of the inquiry involves the placing of a value upon services admittedly rendered. In this connection, "reasonable compensation" has been defined as "such amount as would ordinarily be paid for like services by like enterprises under like circumstances." Accordingly, "unreasonable" compensation has been defined as "salaries in excess of those ordinarily paid for similar services."

Regardless of which of the two issues is predominant in a given fact situation, some general principles can be applied to all reasonable compensation cases. The most basic of these principles is that the taxpayer has the burden of proof and he must produce evidence which at a minimum will overcome the presumption of correctness in favor of the Commissioner of the Internal Revenue Service that the Commissioner's determination is correct. If the taxpayer produces such evidence then the Commissioner must come forward with evidence supporting his position. How well the taxpayer meets his burden will usually determine how much of the claimed compensation deduction will be allowed. Where the taxpayer fails to meet this burden, then the Commissioner's determination will be accepted. Significantly, there appear to be no cases in which the court has made a completely independent determination, that is, allowed a compensation deduction either above that claimed by the taxpayer or below that proposed by the Commissioner.

The second general principle applicable is that the question of reasonableness of compensation is a factual one and each case must be decided upon its own facts. It is only by analyzing the particular business circumstances and the specific employment relationship that the court can determine the proper amount of deductible compensation.

Finally, there is an apparent presumption that in any closely held corporation there will be an absence of arms-length bargaining. Not only is the salary paid to an owner of a close corporation subject to close scrutiny, but so too is it assumed that it is impossible for an arms-length compensatory arrangement to be entered into between such owner and his controlled corporation. Thus in each

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12 Id., § 1.162-7(b)(3).
13 Id., § 1.162-7(b)(1); see also Weise-Winkler Bindery, Inc., 26 CCH Tax Ct. Mem. 1336 (1967).
17 See Harolds Club v. Commissioner, 340 F.2d 861 (9th Cir. 1965).
case where the taxpayer is either a shareholder or a member of a shareholder's family, no weight will be accorded the argument that the compensation was established by contract or negotiated bargaining. This rule has been applied where the compensation was fixed by resolution of the corporation's Board of Directors,\textsuperscript{19} where the compensation was established under a contingent contract;\textsuperscript{20} and where the compensation was established long before the services were actually rendered.\textsuperscript{21}

\textit{Was the Payment for Services Actually Rendered}

Many cases referred to as reasonable compensation cases do not really involve the question of the reasonableness of the amount of compensation at all. In fact, they involve situations in which a payment is made to a shareholder-"employee" and is merely labelled as compensation. Thus, it is required that the personal services either have been rendered in the past or are to be rendered in the future.\textsuperscript{22} An exception to this rule was recently recognized in a case involving a consulting contract.\textsuperscript{23} In \textit{Hatt},\textsuperscript{28} it was held that it was sufficient that one make his services \textit{available} even though no services were in fact ever rendered. Here too, the question of reasonableness would be relevant. The services involved must be rendered to the employer or on behalf of the employer and not to some other person.\textsuperscript{25} Also, the payment must be to the person who rendered the services, and not, for example, to his designee.\textsuperscript{28} An exception exists, however, where the benefits are paid to the widow or other family member of a deceased employee.\textsuperscript{27}

Where no services at all are rendered, the payment may constitute a payment for property,\textsuperscript{28} or it may be a gift,\textsuperscript{29} or the payment may constitute a dividend.\textsuperscript{30} However, there is an inherent danger in claiming a deduction under these circumstances. For example, in \textit{Alicia Ruth, Inc.},\textsuperscript{31} the court held that the taxpayer not only has

\begin{itemize}
\item \textsuperscript{19} E.B. & A.C. Whiting Co., 10 T.C. 102 (1948).
\item \textsuperscript{20} Harolds Club v. Commissioner, \textit{supra} note 18.
\item \textsuperscript{21} Mayson Mfg. Co. v. Commissioner, \textit{supra} note 17.
\item \textsuperscript{22} Sparks Nugget, Inc., \textsection 70.074 P-H Tax Ct. Mem. (on appeal, 5th Cir.).
\item \textsuperscript{23} Herbert G. Hatt, 28 CCH Tax Ct. Mem. 1194 (1969).
\item \textsuperscript{24} Id.
\item \textsuperscript{26} Fort Orange Paper Co., 19 CCH Tax Ct. Mem. 917 (1960).
\item \textsuperscript{27} TREAS. REG. \textsection 1.404(a)-12 (1970).
\item \textsuperscript{28} Lewis & Taylor, Inc., 28 CCH Tax Ct. Mem. 466 (1969).
\item \textsuperscript{29} Raymond A. Biggs, 27 CCH Tax Ct. Mem. 1177, 1189 (1968).
\item \textsuperscript{30} Paul E. Watson, 19 CCH Tax Ct. Mem. 1409 (1960).
\item \textsuperscript{31} 28 CCH Tax Ct. Mem. 262 (1969). \textit{See also} Nathaniel A. Denman, 48 T.C. 439 (1967); Mulder Bros. Inc., 26 CCH Tax Ct. Mem. 217 (1967), where issue of fraud was raised.
\end{itemize}
the burden of showing that services were actually rendered and that the value of the services was equivalent to the amount claimed, but that he also has the burden of demonstrating that no negligence was involved in making the claimed deductions. In *Ruth* payments were made to a 50 per cent shareholder but no evidence was produced to demonstrate that he had performed services. Accordingly, a 5 per cent negligence penalty was imposed in addition to the assessed deficiencies.

**Reasonableness of the Amount**

Once the initial determination has been made that the payment was, in fact, in exchange for services, then the court must decide whether or not the amount of compensation in question represents a reasonable allowance for such services. In making this factual determination, the courts have been guided over the years by a great number of different factors. In the "traditional" compensation case, these factors are carefully evaluated and weighted in light of the particular facts of the case. The factors have been stated to be:

... the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.\(^3\)

It is important to note that in the cases referred to, the principle issue is only that of the value to be placed on the services. The question to be explored hereafter of whether the payment involved was intended to be a distribution of profits taxable as a dividend is usually not relevant in this type of case.

An example of the "traditional" reasonable compensation case is to be found in *Hammond Lead Products, Inc.*\(^3\) The *Hammond* case affords an excellent example of the serious difficulties which the trier of fact encounters in attempting to place a value on the services of employees who admittedly have contributed heavily to the success of a closely held business. In *Hammond*, a father and son for many years operated a successful business. Each had a salary arrangement dating back many years, consisting of a base salary, a percentage of the net income of the corporation and additional incentive compensation. The additional incentive compensation for

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\(^3\) Mayson Mfg. Co. v. Commissioner, *supra* note 17, at 119.  
\(^3\) 28 CCH Tax Ct. Mem. 54 (1969), *aff'd* 425 F.2d 31 (7th Cir. 1970).
the son consisted of $1.00 for each ton of production. In the case of the father, the incentive compensation consisted of $1.00 for each ton of sales. The court found that although the form of the compensatory arrangement was common in the industry and was evidenced by a written contract entered into before the services were performed, the contract was not controlling since it had been entered into between the corporation and its shareholders. Accordingly, since the contract was not the result of arms-length bargaining, a determination could still be made as to the reasonableness of the compensation. \footnote{Id. at 62. See also Harolds Club v. Commissioner, \textit{supra}, note 18.} The court then went on to decide the case on the basis that although both men functioned jointly as the chief executive team for the corporation, the principle factor to be considered was the nature and extent of the services and the qualifications of the employees and their contributions to the success of the business. Here the court made a specific finding that the father's role in running the business was less active and less important than the son's role and, therefore, the son's compensation was found to be reasonable in amount, while a substantial portion of the father's compensation was disallowed as being unreasonable.

Thus, in \textit{Hammond}, the emphasis was not on whether the payment was a distribution of earnings taxable as a dividend. In fact, the company involved paid substantial dividends. \textit{Hammond} makes it clear that the determination under Section 162(a)(1) is to be made independent of any determination of the nature of the disallowed portion of the payment. Whether or not the disallowed payment constitutes a dividend under local law or tax law should not be relevant. The sole issue as to reasonableness of the amount, consequently, should be the proper "value" to be placed on the services.

**DIVIDEND EQUIVALENCY**

Contrasted with \textit{Hammond} are a number of recent cases which serve to demonstrate that the government and the courts appear to be evaluating the various factors which traditionally have resulted in the determination of the reasonableness of the amount of the compensation solely in the context of whether or not the payment involved is in reality a distribution of profits—and thus, equivalent to a dividend. A study of these cases will reflect the judicial criteria being developed to guide the courts in deciding the question of whether all or a portion of the payment a shareholder-employee received was the equivalent of a dividend and taxable as such.

This determination of whether the payment is equivalent to a
dividend typically involves a twofold approach in which the court will first discuss those factors which tend to influence its decision as to the value to be placed on the services and, thus, the reasonableness of the amount. These are the subjective, Hammond-type factors, the most common of which are: (1) the degree to which the particular employee has contributed or contributes to the success financially of the corporation—his particular qualifications; (2) the extent and scope of his actual duties, how much time he expends in the business and how much responsibility he bears; and (3) the comparability of his compensation to compensation of others in similar situations.

Having given some degree of attention to these subjective factors the court will thereafter focus on certain factors which are purely financial in scope. Here, the following factors are significant: (1) the manner in which the payment is made, whether contractual or not; (2) the ratio of compensation to other business financial standards such as gross sales, gross profit or taxable income; and (3) the company's past dividend history. A review of recent cases will illustrate the use of the above factors by the courts and will serve to demonstrate that little weight is now being accorded the subjective factors so that the cases are now being decided solely on the basis of the financial factors—an approach which results in clear and unwarranted discrimination against the close corporation.

In *Craigs Drugstore, Inc.* the salary in question was that of a majority shareholder operating an average size retail drugstore. The particular salary arrangement was such that the employee received a basic salary and a bonus. The bonus was determined pursuant to a contract under which 90 per cent of the corporate profits were divided between the three employee-shareholders of the corporation. The allocation of the contract compensation among the employees was determined by the court to be in the ratio of their stockholdings. The court reviewed the evidence regarding the qualifications of the particular employee and summarized its viewpoint on the value of the services by stating:

> [A]lthough hard work is indeed a traditional manifestation of the American way of life, it is not—even in our affluent society—an open ended justification of any and all payments for such work as reasonable compensation for tax purposes.

The court, though admitting that the employee involved was the principal executive officer of the corporation, concluded that his tasks were clerical in nature and accorded little weight to the tax-

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36 Id. at 1106.
payer's contribution to the success of the business. No evidence was submitted regarding comparable salaries. The court then decided the case on the basis of the financial factors: The amount of profits being distributed as compensation was unusually large; the manner in which the compensation was determined appeared to make it a mechanism for the distribution of profits; and the corporation had paid no dividends. The court thus agreed with the Commissioner that the employee's salary should be allowed only to the extent of $36,000 as opposed to the $48,000 claimed.\footnote{Id.}

In a very recent case,\footnote{The Barton-Gillet Co., 70 P-H Tax Ct. Mem. 750 (1970) (on appeal).} the Tax Court has made it clear that the financial factors will outweigh the subjective factors even where the most favorable of findings are made regarding the qualifications of the employee. In \textit{Barton-Gillet},\footnote{Id. at 759.} the company had been for many years involved in the printing business, but due principally to the extremely competitive nature of the industry, was enjoying little success. In 1955, its operations resulted in a loss. In that year, Mr. Barton, the son of one of the company's founders was employed as president. From 1955 to 1960, a great deal of his efforts were directed at developing the company's business in a specialty printing area. Admittedly, he was singularly responsible for increasing the company's business in specialty printing areas from $500,000 to $1.4 million during the years 1961 through 1966. At the same time, the company's normal business was decreasing from $350,000 to $200,000. The court summarized its feelings on the issue of Barton's worth to the business by stating:

\ldots Barton is demonstrably a man of unusual talents. On his own he developed an approach which could be used with great success by eleemosynary institutions in improving their images and in explaining their purposes and goals to the general public. Through his personal efforts he developed the necessary contracts with the policy makers of various eleemosynary institutions. He possessed the salesmanship ability to induce said institutions to try this new approach. Finally, he oversaw the work done on behalf of each client. The work itself required a great deal of creative thinking.\footnote{Id.}

Thus, the court clearly admitted that Mr. Barton possessed all three of the characteristics of the ideal corporate executive. He was able to develop an idea, sell it and manage its overall application. One might conclude that on this basis there would be little to distinguish Mr. Barton from the Chairman of the Board of General Motors Corporation whose reported annual salary approximates

\footnote{Id. See also Boyle Fuel Co., 53 T.C. 162 (1970).}
However, the court did make a distinction which must necessarily rest solely on the fact that Mr. Barton owned 100 per cent of the outstanding stock of Barton-Gillet Co. It therefore concluded that:

We would of course agree that a controlling shareholder executive is entitled to be paid as a comparable executive of a publicly owned corporation. But this is not to say, where the controlling shareholder sets his own compensation as an executive, that the reasonableness of such compensation does not require a second look by reason of the obvious lack of arm's length bargaining.\(^4\)

With this in mind, the court then discussed the relevant financial factors. The taxpayer pointed out that the majority of Barton’s compensation was determined pursuant to an incentive type of contract common in the industry, and thus ostensibly established that had Mr. Barton been employed by a public company he would have received an identical amount of compensation. The court dismissed this argument on the basis that “we are not impressed with the argument that a sole shareholder can pay himself incentive compensation.”\(^5\) In so stating, the Tax Court apparently adopted the reasoning of the Court of Claims to the effect that a contract which is reasonable with a nonshareholder may be unreasonable if made with a shareholder.\(^6\) There appears to be no basis for such a distinction in the Code.

The court next noted that the ratio of Mr. Barton’s total compensation to the gross profit and net income of the corporation appeared to be high. However, the court’s own ultimate determination resulted in ratios strikingly close to the original ratios:

<table>
<thead>
<tr>
<th>Year</th>
<th>Compensation Proposed by IRS</th>
<th>Compensation Allowed by Court</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964</td>
<td>$60,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>1965</td>
<td>$100,000</td>
<td>$83,000</td>
</tr>
<tr>
<td>1966</td>
<td>$127,000</td>
<td>$108,000</td>
</tr>
</tbody>
</table>

It would appear that the case was decided solely on the basis of the third financial factor considered by the court—the failure of the company to pay any dividends with respect to its common stock. Here, the court stated its position as follows:


\(^{5}\) Barton-Gillet Co., *supra* note 38, at 758. See also Miles-Conley Co. v. C.I.R., 173 F.2d 958 (4th Cir. 1949).

\(^{6}\) *Id.* at 759.

\(^{4}\) Irby Construction Co. v. United States, 290 F.2d 824 (Ct. Cl. 1961); Northlich, Stolley, Inc. v. United States, 177 Ct. Cl. 435 (1966), aff’d 368 F.2d 272 (Ct. Cl. 1966); accord, City Chevrolet Co. v. Commissioner, 228 F.2d 894 (4th Cir. 1956).
While Barton was entitled to be well rewarded, a degree of commensurate recognition should also be given to the contributors of capital. Obviously, in a service-type corporation like the petitioner such contribution does not deserve the recognition that it should receive in a manufacturing corporation, but that is no reason to justify its being totally ignored.45

It is submitted that the Tax Court in actuality concluded in Barton-Gillet that Mr. Barton's compensation was reasonable but that a certain portion of it was necessarily a distribution of profits in the nature of a dividend. There is no support for this position in either the Code or the Regulations. It is significant, however, to note that had the Tax Court chosen to specifically find Mr. Barton's compensation to be reasonable but nevertheless to allocate a certain portion of it as a distribution of profits in the nature of a dividend, it could have found support in a line of Court of Claims decisions.46

In Charles M. McCandless47 the Court of Claims made a specific finding that the compensation involved was reasonable in amount—not only did the employee receiving the payment contribute greatly to the success of the business but his compensation was actually lower than that paid to similar executives in the same industry in accordance with the government's evidence. However, noting that the corporation had never paid a dividend the Court stated:

That any return on equity capital is so conspicuous by its absence as to indicate . . . that the purported compensation payments necessarily contained a distribution of corporate earnings within.48

The Court of Claims then held that a return of equity capital of 15 per cent of net profits before salaries would be reasonable and justified. This is the first and only case which totally ignores the issue of reasonable compensation but determines the amount of a "reasonable dividend" allocable as part of the intended compensation distribution. One could conclude that the Tax Court in Barton-Gillet arrived at the same conclusion, but was reluctant to identify, as a dividend, the amount allocated to excess compensation. In its determination, the Court of Claims cites as the sole authority for its position the case of Klamath Medical Service Bureau.49 It would

45 The Barton-Gillet Co., supra note 38, at 760 (emphasis added).
46 Charles McCandless Tire Service v. United States, 422 F.2d 1336 (Ct. Cl. 1970).
47 Id.
48 Id. at 1339, 1340.
49 29 T.C. 339 (1957), aff'd 261 F.2d 842 (9th Cir. 1959), cert. den. 359 U.S. 966 (1959).
not appear that the *Klamath* case can support either the decision in *McCandless* or in *Barton-Gillet*.

In *Klamath*, a group of doctors were rendering services on behalf of their medical service corporation. Under their arrangement with the corporation the doctor-shareholders received, as compensation for their services, amounts in excess of 100 per cent of their individual billings. The government contended that the entire amount received was in reality a distribution of earnings to stockholders or, in the alternative, if the payments were held to constitute compensation for services rendered, that the entire amount was not deductible because it was unreasonable compensation. This appears to be the first case in which the issue was so presented to the Tax Court. The court recognized that the primary question was whether or not the payments were compensation for services. In this connection it made a specific finding that both the intent of the taxpayer and the manner in which the payments were made indicated that only a certain portion of payments were actually made for services. Accordingly, the court made a specific finding that only a portion of the payments constituted reasonable compensation, and the balance of the payments constituted a distribution of the profits of the taxpayer to be taxed as a dividend. It is clear that in *Klamath* neither the government nor the court maintained that had the entire amount of payments been held to be reasonable a certain portion would have been disallowed as being dividend distributions. The Tax Court, in fact, indicated that had the entire amounts actually been intended to be compensation, a finding could have been made that the payments were reasonable up to the amounts actually paid.\(^50\)

On appeal,\(^51\) the Ninth Circuit affirmed the decision of the Tax Court. The Appellate Court, however, further confused the issue involved by noting that the employment agreement entered into between the taxpayer and its employees obligated it only to pay a fixed amount as compensation (this was the amount allowed by the Tax Court as reasonable compensation). It concluded, therefore, that any additional amounts were purely voluntary payments. Thus, it held that the deduction for these additional amounts would fail on the general test found in Section 162: That the expense to be deductible must be both ordinary and necessary. The Ninth Circuit's point, of course, completely avoided the question that had been put to the Circuit Court by the taxpayer—if the payments are found to be reasonable in amount then the deduction must be allowed in full. It is reasonable to conclude that in both opinions the decision

\(^{50}\) *Id.* at 350.

\(^{51}\) 261 F.2d 842 (9th Cir. 1959).
was based upon a finding that the taxpayer neither intended to pay nor paid, the amounts in dispute for services rendered. The principal proof of this latter fact was that the contract entered into with the employees involved did not provide for such additional payments. On this basis, the decision of the Tax Court appears to be sound.

Soon after the decision in *Klamath* the Court of Claims cited the case as standing for the proposition that:

Even a payment that is reasonable is not deductible if it was actually a distribution of earnings as contrasted with compensation for services rendered.\(^{52}\)

It is clear *Klamath* did not hold that reasonable compensation payments could be disallowed as being distributions of earnings in a close corporation. Where the taxpayer *intends* the payments to be compensatory and actually pays them in a manner consistent with the employment arrangement there can be no basis in Section 162(a)(1) for a contrary holding. Accordingly, it is submitted that the decision and the reasoning of the Court of Claims in *McCandless* is erroneous.\(^{53}\)

A recent District Court case\(^{54}\) seems to approach the problem from yet another vantage point. In *Modern Woodworking*,\(^{55}\) the court stated that where the efforts of the officers of the corporation did not produce any significant net income for the corporation, it could be unreasonable to pay them salaries "which didn't produce anything."\(^{56}\) The court in a jury trial noted that in determining what is reasonable compensation, the nature and amount of the services rendered as compared with the amount of capital investment must be taken into account and a determination made as to how much of the income of the corporation was due to the exercise of personal services and how much was due to the investment of capital. This reasoning appears to introduce the concept that reasonable compensation can be determined only with reference to the net income of the business involved, and would lead to the conclusion that in a business in which there is a capital investment, no matter how small, some portion of the corporation's profits must be allocated to this capital investment and only the balance can be made available for distribution as compensation. It is sub-

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\(^{52}\) Irby Construction Co. v. United States, *supra* note 44, at 827.

\(^{53}\) No appeal is pending in *McCandless*. It should be noted, however, that an appeal from a decision of the Court of Claims lies only to the Supreme Court of the United States.

\(^{54}\) Modern Woodworking, Inc. v. United States, 69-1 U.S. Tax Cas. ¶ 9256 (D. Colo. 1968), *aff’d* — F.2d — (10th Cir. 1970).

\(^{55}\) *Id.*

\(^{56}\) *Id.* at 84, 143.
mitted that this approach to the problem may be sound as compared to the McCandless approach. Here the emphasis is solely on valuing the services. In order to place a proper value on the services to the business purchasing such services, one may necessarily have to consider the position of invested capital. However, this is not to say that all distributions of compensation will necessarily contain a dividend where no dividends have otherwise been paid. In fact the holding in Modern Woodworking was that the compensation payments were reasonable.

The "Reasonable Dividend" Approach

On the basis of the above cases, a new law of reasonable compensation appears to be developing based upon the premise that an owner of a close corporation must consider, in determining a reasonable allowance for compensation, a reasonable return on the capital investment in the corporation. The basis for such a position seems sound if kept in the context of the problem of valuing the services involved. If, however, this line of reasoning is extended so that compensation otherwise reasonable is found to be unreasonable to the extent necessary to allocate a certain portion of the corporate profits to the capital investment, then such a position is unreasonable. There is no support for such a position in the Code and it is obviously discriminatory since it applies only to close corporations. A publicly held corporation may operate at a loss and yet pay its employees whatever salaries are deemed reasonable under the circumstances. Further, there is no merit to the concept that a distribution to an owner-employee must necessarily contain a distribution of profits. Corporations are not required to distribute their profits in the form of dividends and, in fact, many publicly held corporations never distribute dividends at all. Additionally, the Congress has separately provided for the problem of unreasonable accumulations of income in the close corporation.57

Unreasonably Low Compensation

A new dimension has been added to the law of reasonable compensation as a result of two recent cases involving small business corporations electing to be taxed under Subchapter S.58 In Roob59 and Krahenbuhl,60 the Tax Court held that the salaries in question were too low. The issue was not whether a deduction should be allowed under Section 162, but whether the compensation was

57 INT. REV. CODE of 1954, §§ 531-535.
58 Id. § 1375(a)(3).
reasonable in light of the services performed. In both these cases, the Tax Court determined that the shareholder-employees should have paid themselves more compensation. In making this determination the court applied those factors typically applied in the traditional reasonable compensation case. Obviously, the taxpayer did not raise the issue that the compensation of its shareholder-employees was too low, the issue was raised by the Commissioner. Since the income of a Subchapter S corporation is taxed entirely and directly to its shareholders\(^1\) a common tax planning technique involves the transfer of stock to the owner’s children for the purpose of shifting the incident of taxation to the children. Here the effect of the increase in salary was to reshift income back from the children to the parents. It is clear that all family corporation compensation arrangements will be scrutinized in an attempt to eliminate possible artificial shifts of income among family members. However, based upon the results to date under Section 162, the Commissioner may be making a poor choice of weapons in an effort to combat abuses. The basic principle involved here is an important one and in need of further resolution—to what extent can a shareholder-employee of a close corporation contribute his services to the corporation? The Roob and Krahenbuhl cases do not focus clearly on this issue. It is submitted that unless the issue is faced squarely, another endless stream of litigation will result, all under the guise of “reasonable compensation.”

**Professional Corporations**

A great deal of discussion is presently taking place with respect to the proper guidelines for establishing compensation in a pure service corporation such as a professional corporation. Since the advent of the professional corporation laws, a large number of doctors, dentists, lawyers and other professional persons have incorporated professional practices. In many instances, the net income of these practices is extremely high. This immediately raises the problem of the proper allowance for compensation. Take for example, the case of the corporation with a net income of $100,000, all attributable to the services of a given professional person. In deciding the proper amount of compensation for the professional employee there must be taken into account the corporation’s ability to avail itself of the benefits of qualified retirement plans.\(^2\) In a qualified retirement plan, up to 25 per cent of compensation may reasonably be paid to a qualified trust under a retirement program

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\(^1\) See **Int. Rev. Code** of 1954, §§ 1371-1377.

\(^2\) See generally, Id. §§ 401-404.
established by the corporation for the benefits of its employees.\textsuperscript{63} Using the 25 per cent as a basis for contributions to the qualified plan, the professional man could receive an $80,000 cash salary from this corporation and $20,000 in deferred compensation in the form of a retirement plan contribution. It is well settled that the term "compensation" as used in Section 162, includes both non-deferred and deferred compensation and that contributions to retirement plans are a form of deferred compensation.\textsuperscript{64} Thus, for purposes of determining whether or not the compensation allowance is reasonable, the entire $100,000 would be taken into account.

There are only two cases which directly discuss the issue of the proper amount of compensation which may be paid to the professional man.\textsuperscript{65} The holding in \textit{McClung Hospital, Inc.},\textsuperscript{66} appears to provide some sound guidelines for planning. In that case, the McClung family, all doctors, were operating a hospital. Two of the McClungs performed full-time and substantial services while the elder McClung, the father, was much less active. The Commissioner took the position that compensation equal to 100 per cent of the aggregate fees billed was apparently unreasonable since all other doctors employed by the hospital were paid a lesser proportion of patient fees after reduction for various overhead expenses and uncollectible accounts. The court followed the reasoning in \textit{Klamath Medical Service Bureau} and held that compensation for the two active McClungs was not unreasonable simply because it represented 100 per cent of fees billed without reduction for any other overhead expenses. In light of the services performed their compensation was held to be reasonable. However, in the case of the elder McClung, the court found that he did not perform any substantial services and that, therefore, his compensation could not be computed using as a basis the aggregate fees billed by all three family members. Accordingly, the court allowed only a small portion of the father's actual compensation as a deduction. \textit{McClung} seemingly stands for the proposition that where a professional person is performing substantial services, 100 per cent of his fees billed (without reduction for overhead) might constitute reasonable compensation.

It is clear, however, that the theories involved in cases such as \textit{Barton-Gillet, McCandless} and \textit{Modern Woodworking} would readily apply to the professional corporation. As a result very

\textsuperscript{63} The statutory limits under Section 404 permit greater contributions under certain circumstances, but 25 per cent is the maximum allowed where the corporation has adopted both a profit-sharing and a pension plan. \textit{Id.} § 404(a)(7).

\textsuperscript{64} \textit{Treas. Reg.} § 1.404 (1970); The Barton-Gillet Co., \textit{supra} note 38, at 759.

\textsuperscript{65} \textit{Klamath Medical Service Bureau}, \textit{supra} note 49; McClung Hospital, Inc., 19 CCH Tax Ct. Mem. 449 (1960).

\textsuperscript{66} \textit{Id.}
serious consideration should be given to the role of invested capital, however small, in the distribution of profits.

**Reimbursement Agreements**

The effect of an adjustment to a compensation deduction is solely related to the payment of the deficiency arising on account of the disallowance. Since the amount involved has been paid out no adjustment need be reflected upon the books other than a reclassification from salary to dividend. Frequently, consideration will be given to the idea that the disallowed compensation should be repaid to the corporation by the person receiving such compensation. If the person making the payment were to receive a deduction in the year of the payment, his personal tax position might be substantially the same as it would have been had he not reported the income originally. From the corporation's viewpoint, it will receive the necessary funds with which to make the deficiency payment. Obviously, a shareholder in the 48 per cent tax bracket in both the year of receiving the payment and the year of repayment will still be out-of-pocket a net of 52 per cent of the amount he originally received. The corporation, if taxed at the 48 per cent tax bracket, will find its surplus increased by 52 per cent of the amount received from the employee. These economic results should be considered carefully before entering into such arrangements with the corporation. In many closely held corporations the payment of additional taxes may serve to reduce surplus in a manner which may assist in alleviating the danger of the corporation being subjected to the tax on unreasonable accumulations. Further, the shareholder involved may no longer have the funds with which to make a repayment. Where the decision is made to provide for repayment, careful consideration should be given to the three decided cases and to Revenue Ruling 69-115.

In each of the decided cases, the issue was whether the taxpayer would be entitled to an ordinary and necessary business expense deduction for an expenditure directly connected with or pertaining to the taxpayer's trade or business. The general rule that has developed is that the portion of the amounts repaid to the corporation which represent excessive salary and which is made under a legal obligation to make such repayment is deductible under Section 162. It would appear that only where the repayment agreement is entered into prior to the payment of the salaries in question

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would such an agreement constitute an enforceable obligation under applicable State law. Thus, where the repayment agreement is entered into after the salary is paid out but before the disallowance is proposed, the amount repaid would not be deductible. This repayment agreement may be evidenced in the bylaws of the corporation.

SUMMARY

Over the years Section 162(a)(1) has been the subject of a steady stream of litigation. It should be clear from the foregoing discussion that recent cases have added new judicial constructions to the Section and consequently new dimensions to future litigation. The courts appear to be developing an attitude towards the close corporation which would effectively prohibit such corporations from setting compensation for its shareholder-employees in accordance with common business practices. It is one thing to say that a salary is unreasonable because the employee did not earn it. It is quite another thing to say that it is unreasonable simply because the employee is also a stockholder. Yet in a recent case the Fifth Circuit stated that:

The supervisory services that the president performed are the kind that might be expected of a major shareholder who would look to dividends rather than salary for his compensation.

The inference from the foregoing statement is clear. Unless a change is made in this thinking the veil of the closely held corporation will be judicially pierced, a result neither intended nor warranted under the statute.

70 Blanton, supra note 67.
71 Oswald, supra note 67.