Discerning compensation from dividends for shareholder-employees

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Introduction

The practice of exhausting corporate net income in the form of compensation to shareholder-employees is a hot issue for personal service corporations (PSCs). Unlike other corporations, PSCs are not allowed to utilize graduated tax rates (that is, incrementally higher tax rates as taxable income reaches certain levels). Rather, PSCs pay corporate income tax at a flat 35 percent rate beginning with the very first dollar of taxable income. As a result, PSCs often attempt to reduce corporate taxable income to $0. One of the most common strategies used by PSCs to achieve this result is to pay compensation to the shareholders in the form of large salaries and/or year-end bonuses.

Compensation paid to shareholders is a deductible expense to the corporation, whereas dividends payments to shareholders are not deductible by the corporation. Therefore, payments to shareholders in the form of compensation rather than dividends results in a lower overall tax bill to the corporation/shareholder group. As such, the IRS frowns upon excessive compensation paid to shareholders in a corporation, again, especially with PSCs.

The IRS is cracking down on corporations that attempt to disguise payments to shareholder-employees as compensation rather than dividends. There are no hard-and-fast rules for estimating reasonable compensation, so it can be difficult for professional corporations to determine what constitutes a "reasonable" allocation of payments between compensation for services rendered and payments as a return on investment.

RECENT TAX COURT DECISION

In a recent Tax Court case, *Brinks Gilson & Lione PC*, TC Memo 2016-20, the Tax Court upheld the IRS's imposition of accuracy-related penalties against a law firm related to underpayments resulting from the firm's ***conceded mischaracterization*** of dividends it paid to shareholder-attorneys as deductible compensation for services. In this case, the law firm employed approximately 150 attorneys (of which 65 are shareholders) as well as approximately 270 non-attorney employees.

The Board of Directors would estimate the amount of available compensation for shareholders, which was generally proportionate to their respective stock ownership percentages. As this was just an estimate, only a percentage of their compensation would be received throughout the year as salary payments. Near the end of the year, a bonus would be calculated to "zero-out" any remaining book income.

The IRS examined the firm's 2007 and 2008 tax returns and disallowed various deductions – most notably, the year-end bonuses. The net result was the firm owed $1.1 million and $1 million of tax to the IRS in 2007 and 2008. The IRS also imposed penalties of $222 thousand and $203 thousand (respectively) due to the substantial understatement of tax.

The law firm appealed the penalties and argued it had substantial authority.

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Failed taxpayer arguments vs successful IRS arguments

1 **The taxpayer argued that even if these amounts were not deductible bonuses to the shareholders, they should be classified as deductible interest expense – because a stock purchase is essentially a loan, and payments to shareholders were more like an interest expense:**

- The argument of deductible interest was "readily dismissed" due to the fact that shares of stock purchased by the shareholders lacked any "hallmark characteristics of debt," such as:
- Shares of stock contained no fixed maturity date, no payment schedule, no stated interest rate, etc.

2 **The taxpayer argued it had reasonable cause to deduct the year-end bonuses because it relied on a reputable accounting firm to prepare its returns during the years under issue:**

- The Tax Court stated there was no evidence the accounting firm advised the taxpayer on the deductibility of the bonuses
- Further, it was ruled the taxpayer supplied the accounting firm with inaccurate information because it provided the accounting firm with information stating payments were compensation for services via Forms W-2

3 **Taxpayer cited the *Ashare* case as support. In the *Ashare* case, the Tax Court allowed a corporate law firm to deduct compensation amounts paid to the sole shareholder that exceeded the firm's revenues for the year in question:**

- The court rejected this argument, as the *Ashare* case was a one-year issue, not a consistent practice by the company to eliminate all income. In the case before the court, the firm had not declared a dividend at least 10 years prior to the years at issue.

4 **Taxpayer argued they had reasonable cause to deduct the bonuses based on the fact they had been audited in an earlier year and the previous audit didn't have any adjustments related to shareholder compensation/year-end bonuses**

- This argument was rejected because a "no-change" letter alone does not establish reasonable cause
- It was further determined the agent who audited the previous year's return did not address the issue of year-end bonus deductibility, nor was that agent supplied with sufficient information to have possibly addressed the issue

5 **The IRS also argued amounts paid to corporation shareholder-employees are not a deductible compensation expense to the extent these payments were generated by services provided by non-shareholders or from the use of the *corporation's* intangible assets.**

- The IRS cited the Pediatric Surgical Associates, TC in a Memo where the Tax Court held payments to shareholder employees which were attributable to the services of non-shareholder employees were dividends

Critical items to note

- **The decision was based in part on the firm failing the independent investor test.** The court rejected the firm's arguments that a law firm cannot have an independent investor. All shareholders of a law firm must be practicing attorneys.
- **While year-end bonuses were paid based on regular compensation, the fact that it was also paid in proportion to stock ownership was damaging to their case.**
- **Associates were paid bonuses during the year, but not at year-end.** If bonuses for all employees were paid at the same time, it would help support the argument that bonuses were not paid strictly to manage income, but were based on both individual and firm performance.
- **Stock ownership mirrored compensation.** Many professional firms annually adjust ownership to coincide with compensation. We recommend against this practice. Ownership and compensation arrangements should remain as independent as possible with separate criteria for each.
- **No dividends were paid despite substantial capital.** If a professional service firm has substantial capital invested, we may recommend a dividend policy be established.
- **The firm conceded the underlying issue without obtaining penalty relief.** Waiver of penalties should always be part of any agreement with the IRS.

Documentation, documentation, documentation

Documentation is crucial to support above average compensation for shareholder-employees.

- Special certifications and qualifications
- Linking the shareholder's services to extraordinary company success, e.g., the company can show that since a shareholder joined the corporation, the success of the company increased significantly as a result
- Consistent application of compensation program from year to year

The Dos and Don’ts of shareholder-employees compensation

Do	Don’t
> Be proactive in documenting shareholder compensation arrangements in corporate minutes > Tie compensation to services provided, not stock ownership > Anticipate steady, consistent growth in compensation from year to year > Consider payment of dividends when large capital is invested by the shareholders	> Wait to determine shareholder compensation arrangements until after an audit > Tie shareholder compensation to stock ownership percentages > Expect substantial spikes in compensation > Use compensation as a tool to wipe out the corporation’s income

How Baker Tilly can help

Baker Tilly has a team of industry experts in the professional services area that reviews compensation arrangements and corporate minutes, compares items with industry benchmarks, and potentially identifies weaknesses. We will ensure your shareholder-employees are being adequately paid while still upholding challenges from the IRS.

If you are interested in learning more or have any questions, please visit bakertilly.com/contact.

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