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ESTABLISHING REASONABLENESS OF COMPENSATION DIFFICULT IN IRS ATTACKS

by

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INTRODUCTION

Reasonable compensation issues generally involve a determination of an adequate level of compensation for a shareholder-employee of a closely held corporation. Compensation above the determined "adequate level" is considered excessive and is classified as a nondeductible dividend. Reasons cited for the payment of large salaries include the reduction of the likelihood of an accumulated earnings tax and the double taxation of dividends. However, when individual tax rates were lowered by the Tax Reform Act of 1986¹ and payroll taxes sharply increased, compensation in the form of dividends from S corporations became more attractive to their respective shareholder-employees.

With this in mind, reasonable compensation determinations have developed a different twist for shareholder-employees of Subchapter S corporations. As the payroll tax burden continues to increase, it now appears that the respective positions of the taxpayer and the IRS in issues of reasonable compensation, at least in the case of S corporations, are being reversed. Thus the issue has turned to how small, rather than how large, a shareholder-employee's salary may be and still be considered reasonable.

The topic at hand centers around minimizing the payroll tax burden of the shareholder-employee. In recent years, payroll taxes have increased substantially in amount, both from an increasing tax rate and an increasing base. Annual payroll tax collections for social security amount to approximately \$329 billion, of which \$266 billion will be paid out in benefits. Recently, much debate has centered around these surpluses and the ever-growing payroll tax burden shouldered by America's "wage earners". However, although Congress appears to be considering a reduction in payroll taxes, to date, only increases in social security taxes have been legislated.

The most recent change in payroll taxes was effected by the Omnibus Budget

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¹ Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

Reconciliation Act of 1990,² which substantially increases the Medicare hospital insurance (HI) portion of the FICA tax. While the wages and self-employment income cap on the portion of the FICA tax based on old-age, survivor and disability insurance (OASDI) increases from \$51,300 for 1990 to \$53,400 for 1991, the cap on wages and self-employment income used in calculating the HI portion of the FICA tax increases from \$51,300 for 1990 to \$125,000 for 1991, effective January 1, 1991.³ The aggregate effect of the increases to the income cap limitations for OASDI and HI is a potential FICA tax increase for 1991 (both employer and employee share) of \$2,398 as compared with 1990, for a salary of \$125,000 or more. This translates into a potential FICA tax increase of 30.5% from 1990 to 1991, for a shareholder-employee earning a salary of at least \$125,000. When the total amount of FICA tax (or some portion) is multiplied by several shareholder-employees per corporation, the tax savings become more apparent. For example, if a salary of \$30,000 were paid to each of four shareholder-employees instead of \$53,000 for each individual, the 1991 total FICA tax savings would amount to \$14,076 [(\$53,000-\$30,000 x 15.3%)x4]. It is apparent why such changes have motivated many small businesses, through the use of the S corporation form, to shift (or at least consider shifting) from larger to smaller salaries, with a complementary shift in dividends (actual and constructive). Since dividends are not subject to payroll taxes, this strategy can lead to considerable FICA tax savings. Unfortunately, such a strategy may possibly lead to an IRS audit, litigation, and the imposition of additional taxes and penalties. Considering that the taxpayer has won only about twenty percent of all inadequate compensation cases litigated to date, it is advised that caution be exercised in establishing shareholder-employee compensation.

STATUTORY PROVISIONS

An implicit requirement of Treas. Reg. § 1.162-7⁴ is the determination of a reasonable level of salary and total compensation vis-a-vis the services provided by an employee-shareholder. However, ascertaining the reasonableness of compensation is a highly factual and subjective issue. Under Treas. Reg. § 1.162-7,⁵ deductibility is based upon two criteria: an "amount" test and a "purpose" test, both of which only provide general guidelines. The "amount" test requires that compensation for personal services be reasonable in relation to the amount of services performed. The "purpose" test distinguishes between payments made solely for services rendered compared with payments for the purchase or use of property. Under both tests, the position of the taxpayer traditionally has been one of trying to prove that a given salary was proper after the IRS had disallowed a portion of the amount claimed by the taxpayer.

² Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1 (1990).

³ *Id.* at § 11331(a)-(d), 104 Stat. 1, 467-68.

⁴ Treas. Reg. § 1.162-7 (1958).

⁵ *Id.*

In the cases related to inadequate compensation and payroll taxes, multiple references are made by the IRS to I.R.C. §§ 3121(a),⁶ 3121(d),⁷ 3306(b),⁸ and 3306(i)⁹ and Treas. Reg. § 31.3121(d)-(1).¹⁰ These authoritative sources of law provide little guidance beyond simply stating that wages are subject to FICA and FUTA taxes. The lack of guidance provided by each of these sources was illuminated by the Tax Court's statement that none of the documentation defines remuneration, nor does it except dividends from payroll taxes.

IRS GUIDELINES

According to Rev. Rul. 74-44,¹¹ S corporation distributions can be reclassified as wages when uncompensated services are performed by the shareholder and employment taxes are avoided by not paying salaries.¹² Like the aforementioned statutory sources of law, Revenue Ruling 74-44¹³ implicitly requires that a determination be made regarding (1) what constitutes wages and salary and (2) the reasonableness of total compensation vis-a-vis the services provided by an employee-shareholder. To assist field personnel in making the latter determination, the IRS issued IRS Manual 4233, § 232.2¹⁴ on March 11, 1985. In determining a reasonable range of possible salary levels for S corporation shareholder-employees, IRS audit personnel will analyze certain factors identified in the manual in a manner consistent with an independent party making a determination of an adequate compensation level for an employee.

It is interesting to note that the factors identified in the manual are designed for excessive compensation cases; there are no factors explicitly stated for judging compensation deemed to be inadequate. However, it can be inferred that the logic behind the factors identified for judging whether compensation is excessive, if used in the opposite manner, can be used as the basis for making an inadequate compensation determination.

Factors to be taken into consideration for determining the reasonableness of shareholder-employee compensation are: the nature of duties, background and expertise, knowledge of the business, size of the business, employee's contribution to profit making, time devoted, economic conditions in general and locally, character and amount paid by a similar size business in the same area to equally qualified employees for similar services.

⁶ I.R.C. § 3121(a) (1986).

⁷ I.R.C. § 3121(d) (1986).

⁸ I.R.C. § 3306(b) (1986).

⁹ I.R.C. § 3306(i) (1986).

¹⁰ Treas. Reg. § 31.3121(d)(i) (1980).

¹¹ Rev. Rul. 74-44, 1974-1 C.B. 287.

¹² Rev. Rul. 74-44, 1974-1 C.B. 287.

¹³ Rev. Rul. 74-44, 1974-1 C.B. 287.

¹⁴ I.R.M. 4233, § 232.2. (March 11, 1985).

Another factor that is considered in evaluating the reasonableness of compensation in corporations is shareholder-employee compensation from related corporations. Additionally, dividends to shareholder-employees will be scrutinized to ascertain if such amounts actually represent bonuses.

In examining the factors to be considered in evaluating compensation, the following may be inferred:

- (1) if duties are minimal and undemanding, a low salary is justified;
- (2) little or no experience should justify lower salary;
- (3) a limited knowledge of business justifies smaller salaries;
- (4) smaller businesses can justify smaller salaries;
- (5) if an individual's contribution to profit is minimal, a lower salary is justified;
- (6) the less time devoted to the business, the less the salary;
- (7) poor economic conditions may necessitate a smaller salary;
- (8) less responsibility necessitates a lower salary;
- (9) if compensation is determined at the beginning of the year, it is probably not a dividend;
- (10) if a stockholder receives a cash distribution unequal to his/her ownership percentage, it may be viewed as salary;
- (11) the amount paid to the stockholder-employee is the going salary for similar-sized businesses; and
- (12) the need for the use of funds for capital improvements, working capital, or physical expansion may justify a smaller salary.

Additionally, companies which are growing at a slower rate may have justification for lower salaries. Salaries are expected to be higher in periods of prosperity and inflation while lower in years of recession and stagflation. Sources to which the IRS will look to in evaluating the above factors are (1) trade association statistics, (2) published registration statements by the SEC, (3) newspaper advertisements in the employment section and (4) employment agencies. In fact, the manual states that there are no guidelines to determine what amount or proportion of salary ought to be paid by the corporation. Thus, establishing a reasonable range of compensation remains largely a question of fact.

JUDICIAL RULINGS

For the last three decades, several cases have been heard that relate to the issue of inadequate compensation. The taxpayer has won only about twenty percent of the total inadequate compensation cases litigated, which compares quite unfavorably to the approximate 50-50 won/lost record with excessive compensation cases. However, unlike excessive compensation cases, which usually involve additional taxes

from both corporate and individual taxpayers, the current inadequate compensation cases usually involve only additional payroll taxes.

The Taxpayer is Victorious

In *Rocco v. Commissioner*¹⁵ and *Davis v. Commissioner*¹⁶ the IRS attempted to reallocate 100 percent of the S corporation income as salary rather than dividends. In both cases, the IRS tried to persuade the courts that in addition to the powers conferred under I.R.C. § 1375(c)¹⁷ (which transfers the burden of proof to the taxpayer) it should also be given the additional rights of reallocation under I.R.C. § 482,¹⁸ thus increasing the taxpayer's burden to one of proving that the IRS's determination was unreasonable, arbitrary, or capricious. In *Rocco*,¹⁹ the taxpayers were shareholder-employees who worked about five hours a week performing mainly ministerial duties for the corporation. In *Davis*,²⁰ an orthopaedic surgeon created two corporations to perform X-ray and physical therapy on patients referred primarily by Davis. Davis assigned 90 percent of the stock in the two corporations to his three minor children and then made subchapter S elections. Davis worked only about 20 hours annually for the corporations. In both cases, the court ruled in favor of the taxpayer, stating that the time spent working on corporate activities was insignificant. Further, in both cases, the court concluded that it did not need to rule on the applicability of I.R.C. § 482²¹ since it found that the IRS had exceeded the reallocation rights under I.R.C. §§ 1375(c)²² and 482.²³

An additional factor emerged from *Rocco*²⁴ and *Davis*.²⁵ The court relied heavily upon the explanation contained within Treas. Reg. § 1.1375-3(a)²⁶ that states: "In determining the value of services rendered by a shareholder, consideration shall be given to all facts and circumstances of the business, including the managerial responsibilities of the shareholder, and the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the corporation." In *Rocco*,²⁷ the court noted that Treas. Reg. § 1.1375-3(a)²⁸ in substance incorporated the traditional standard of I.R.C. § 162(a)(1)²⁹ in determining a "reasonable allowance for salaries or the compensation for personal services

¹⁵ *Rocco v. Commissioner*, 57 T.C. 826 (1972).

¹⁶ *Davis v. Commissioner*, 64 T.C. 1034 (1975).

¹⁷ I.R.C. § 1375(c) (1986).

¹⁸ I.R.C. § 482(1986).

¹⁹ *Rocco*, 57 T.C. 826 (1972).

²⁰ *Davis*, 64 T.C. 1034 (1975).

²¹ I.R.C. § 482 (1986).

²² I.R.C. § 1375(c) (1986).

²³ I.R.C. § 482 (1986).

²⁴ *Rocco*, 57 T.C. 826 (1972).

²⁵ *Davis*, 64 T.C. 1034 (1975).

²⁶ Treas. Reg. § 1.1375-3(a) (1958)

²⁷ *Rocco*, 57 T.C. 826 (1972).

²⁸ Treas. Reg. § 1.1375-3(a) (1958).

²⁹ I.R.C. § 162(a)(1) (1981).

actually rendered.' In *Davis*,³⁰ the court reaffirmed these standards under Treas. Reg. § 1.1375-3(a),³¹ noting that the determination is one fact that should be applied to the traditional factors of reasonable compensation.

Tips From the Winners

The nature, extent, and scope of the employee's work is a major factor in determining if the compensation paid is reasonable. The activities of the employee and the amount and character of services provided may all be important factors considered in ascertaining the reasonableness of compensation.³² Smaller salaries may be justified where the business's success was not a result of the employee's expertise and managerial skills. It may be wise to argue that the business would have succeeded regardless of any actions or efforts by employees, perhaps because of a favorable location, a unique and highly demanded product or service, or positive economic conditions.

The time contributed to the business may be a secondary factor to the nature, extent, and scope of the taxpayer's work in determining reasonable compensation. The courts are likely to look to the total number of hours worked during the year in judging the reasonableness of compensation.³³ The courts appear to agree with the contention that employees with erratic or fluctuating working hours and employees working only part-time should normally receive less compensation than employees working fixed schedules or on a full-time basis.

The Taxpayer is Defeated

In *Roob v. Commissioner*,³⁴ the question of inadequate compensation in an S corporation came before the Tax Court in connection with the reallocation of income by the IRS under former I.R.C. § 1375(c),³⁵ which gave the IRS powers similar to the current I.R.C. § 1366(e).³⁶ Walter and Mary Roob, the taxpayers, operated a photographic studio known as Roob Studios, Inc., which elected to report its income as an S corporation. Although operating activities were performed exclusively by the taxpayers, the ownership of Roob Studios, Inc. was divided equally among the Roobs and their eight children. The taxpayers received salaries of \$10,000 each for 1962 and \$12,000 each for the years 1963 and 1964, while the other shareholders (the

³⁰ *Davis*, 64 T.C. 1034 (1975).

³¹ Treas. Reg. § 1.1375-3(a) (1958).

³² See *Webster Tool and Die, Inc. v. Commissioner*, 54 T.C.M. 604 (1985); *G.R. Laure v. Commissioner*, 70 T.C. 1087 (1978) *aff'd* on this issue (CA-6) 81-2 USTC; *Home Interiors & Gifts v. Commissioner*, 73 T.C. 1142 (1980); *M.J. Laputka and Sons, Inc. v. Commissioner*, 50 T.C.M. 730 (1981); *Capitol Finance Co. v. Commissioner*, 42 T.C.M. 206 (1972).

³³ See *Levenson and Klein, Inc. v. Commissioner*, 67 T.C. 694 (1977) and *A. Van Luit Co. v. Commissioner*, 44 T.C.M. 56 (1975).

³⁴ *Roob v. Commissioner* 50 T.C. 891 (1968).

³⁵ I.R.C. 1375(c).

³⁶ I.R.C. § 1366(e) (1982).

taxpayer's children) received only dividends. The court agreed with the IRS's determination that Walter Roob's salary for the years 1962-1964 was inadequate because the taxpayers' single defense, a survey of comparable executive salaries, was deemed statistically unreliable. The court agreed, too, with the IRS's contention that a reasonable salary for Walter Roob was \$14,000 for 1962, \$17,000 for 1963, and \$20,000 for 1964. The court noted that while the issue represented a reversal of the traditional reasonable compensation issue (i.e., excessive compensation paid to the shareholder-employee), the criteria relied on in deciding the issue in such cases (i.e., inadequate compensation paid to the shareholder-employee) seemed to apply with equal force. Thus, factors deemed relevant in deciding prior excessive compensation cases--the nature of the services performed, the responsibilities involved, the time spent, the size and complexity of the business, prevailing economic conditions, compensation paid by comparable firms for comparable services, and the salary paid to company officers in prior years--were also relevant in determining whether the taxpayer's salary was reasonable or inadequate.

In making its determination in *Roob*,³⁷ the court cited the long hours worked by the taxpayers in performing not only managerial functions but also sales activities, including lectures for photographic associations. The court also noted that the taxpayers were the recipients of numerous awards for craftsmanship and that, ultimately, the efforts of the taxpayers had resulted in a dynamic corporation whose sales over a 15-year period had increased by almost 160 percent. The court also noted that the section under which the IRS reallocated dividends as salary effectively shifted the burden of proof to the taxpayer. Thus, it became the taxpayer's task to prove that the reasonable value of his services did not exceed the salary he received from the business. Finally, the income reallocated to Roob was considered dividend income, even though the basis for reallocation was an inadequate salary. Therefore, the reallocated income was not deductible by the corporation.

In *Krahenbuhl v. Commissioner*,³⁸ the IRS claimed that the taxpayer's 1963 salary of \$4,800 and 1964 salary of \$7,200 were inadequate in light of the services performed by the taxpayer. The Tax Court held that a reasonable salary for the taxpayer was \$7,200 a year for each of the years in question. In making its determination, the court considered (1) the nature and extent of services provided to the corporation and Krahenbuhl's competency and skill as an electrical contractor and (2) his prior salary as an employee of an electrical contractor. The court found that Krahenbuhl's services provided to the corporation--bidding on jobs, planning and supervising employee activities, and purchasing materials--were, in effect, the whole corporate "show". Further, the court considered the fact that Krahenbuhl worked for the corporation approximately 14-16 hours daily in the performance of activities similar to those under his prior job, which had paid about \$7,500 a year. Finally, the court noted that in arriving at the \$7,200 figure it considered that the

³⁷ *Roob*, 50 T.C. 891 (1960).

³⁸ *Krahenbuhl v. Commissioner*, 37 T.C.M. (P-H) 34 (1968).

corporation was in its infancy and without experience in the setting of salaries or expectation of profits.

In *Bramlette Building Corp.*,³⁹ the taxpayer, Joseph Bramlette operated his real estate management activities in Longview, TX., under S corporation status. He was the corporation's president and owned 99.86 percent of the outstanding stock. The corporation's management services consisted of managing one office building in downtown Longview. The corporation employed 10 persons who were supervised by Bramlette. The corporation neither authorized nor paid Bramlette a salary nor was there an agreement or authorization for a salary to be paid during the years in question. The corporation paid dividends to Bramlette in 1963 and 1964 in the amounts of \$8,160 and \$7,200, respectively. Upon audit, the corporation had its S corp status terminated due to the receipt of more than 20% of its gross receipts from "rents" resulting in the corporation being reclassified as a C corporation for 1963 and 1964. When the corporation lost its S status, Bramlette argued that the dividend payments were compensation which would be deductible by the corporation, while the IRS stated that the payments were, in fact, non-deductible dividends. The dividends, the IRS argued, were paid by the C corporation, and were subject to taxation at both the corporate and individual level.

The 5th Circuit stated that whether a payment is compensation or dividend is a question of fact; that mere labelling of a payment as a dividend is only evidence of its character, and that the label should be accorded even less weight than usual in this case since dividends and salary in a S corporation are treated similarly for tax purposes. The court listed several factors it considered in making a dividend/salary determination.

- 1) The services provided by Bramlette were no more than anyone who was a large stockholder and a director in the enterprise would perform;
- 2) There was no corporate authorization for the payment of salaries;
- 3) Consideration of book entries, whether amounts are withdrawn periodically or in a lump sum;
- 4) Whether the payments bear a relationship to the earnings of the corporation;
- 5) Whether all shareholder-employees receiving equal amounts rendered equal services; and
- 6) The relationship between net income and compensation paid.

The court decided that the supervisory services provided by the president were of a kind that might be expected of a major shareholder who would look to dividends rather than salary for his compensation. Furthermore, the court decided that the payments were made not in proportion to the services the president rendered but in

³⁹ *Bramlette Building Corp. v. Commissioner* 52 T.C. 200 (1969).

proportion to the profits of the corporation.

Even though the taxpayer performed services for the corporation, it apparently was given little weight in the courts consideration of whether a part of the dividend should be reclassified as a salary. If services are performed that benefit the corporation and the corporation would have to pay someone else for such services, it may be implied that some salary is necessitated. It appears the court gave great attention to the fact that an employment contract was not entered into. Thus it seems that the IRS will argue the case not so much on the facts but on its desired outcomes to dividends or salary. For instance, if the corporation was still a S corp, the IRS could probably successfully argue that the services were not compensated and that a portion of the S dividend should be reclassified as salary.

In *Electric & Neon Inc.*,⁴⁰ the taxpayer made withdrawals from his corporation which he classified as loans which were nontaxable. The outstanding balance of the loans was \$2,011 on January 1, 1961 and grew to \$97,733 by the end of 1967. The IRS reclassified these loans as dividends therefore making them nondeductible to the corporation and taxable to the shareholder. The taxpayer argued that a great portion of such amounts represented compensation and should be deductible by the corporation.

During the years in question the taxpayer performed substantial services for the corporation. Electric & Neon was essentially a one-man operation: the taxpayer had full responsibility for running the business, and he worked regularly in excess of 60 hours per week to discharge such responsibilities. An officer of a similar corporation was of the opinion that the services performed by the taxpayer were similar to those performed by the president, the vice president, a salesman, and a supervisor of that corporation. Additionally, this company offered the taxpayer a job, which he rejected, as a salesperson with a guaranteed salary of \$15,000 per year. The taxpayer, however, estimated that his sales commissions could have brought the annual income up to \$25,000. Electric & Neon paid the taxpayer a salary ranging from \$9,000 to \$12,100 from 1961 through 1967. Such amounts were included on his tax return and deducted as salary expense on the corporate return.

The IRS maintained that the amounts which the taxpayer received from Electric & Neon in excess of his stated salary were not intended to be paid as compensation. And as stated prior, it is settled law that such intent must be shown as a condition precedent to the allowability of a deduction to the corporation. The court noted that the taxpayer did not testify that withdrawals in excess of his stated salary were intended to compensate him additionally for his services; rather, his testimony, with respect to intent, was in support of the loan argument, which was rejected. The argument that the distributions were loans does not negate the alternative argument that compensation was intended. The court felt that if he really

⁴⁰ *Electric & Neon, Inc. v. Commissioner* 56 T.C. 1324 (1971).

believed the withdrawals were compensation, he would have reported it as such on his tax returns. Likewise the corporation would have deducted the payments as compensation, which it did not.

The court further stated that it thought that the amounts withdrawn were geared more to the extent of his personal needs than to the value of the services performed. There was no evidence to indicate that his services were worth more in any one year than another, yet the amounts of withdrawals fluctuated sharply. Such fluctuations, unrelated to the amount of services performed, did further damage to the tax payers contention that compensation was intended.

The taxpayer argued that the services rendered were substantially greater than the stated salary as evidenced by the testimony. However, the court stated that such evidence show merely that the taxpayer could have been paid significantly more compensation; it did not establish that the withdrawals were intended as additional compensation. Thus, the corporation was denied a deduction for an adequate level of compensation.

In *Paula Construction*,⁴¹ two brothers owned 50 and 45 percent, of the outstanding stock of Paula Construction, a small business corporation (S corp) formed in 1958. The shareholders understood the advantages and disadvantages of being an S corporation and that the payment of a dividend or compensation and the undistributed earnings of the company would be taxable income to them.

The brothers performed substantial and valuable services for and on behalf of Paula in connection with the construction and financing activities of the firm. In 1965 Paula distributed \$29,700 to its stock holders on a pro rata basis of shares owned and did likewise in 1966 by distributing its entire net income of \$43,971. Neither the companies books, nor its corporate minutes made any reference to salaries or the possibility of salaries being paid to either brother. Additionally, the Paula tax return did not contain any references to any deduction for salaries and wages, nor for any deduction for compensation paid to officers. The individual tax returns filed by the brothers also indicated that no salary was received from Paula. The distributions received by the brothers during the years in question, 1965 and 1966, were reported as distributions from the S corporation.

When the Paula tax returns were filed for 1965 and 1966, its officers were not aware that they no longer qualified as an S corporation, and were reclassified as a regular C corporation. Thus, as a C corporation upon audit, they tried to claim that a portion of the distributors were for compensation to officers. Regulation 1.162-7(a) provides that the test of deductibility in the case of compensation payments is whether they are reasonable and are in fact purely for services. The IRS agreed that the brothers performed substantial services for Paula during the years in questions

⁴¹ *Paula Construction Co. v. Commissioner* 58 T.C. 1055 (1972).

and that, if portions of the distributions were treated as compensation, the \$27,000 would be a reasonable deduction for each of those years.

The Tax Court stated that, "it is now settled that only if payment is made with the intent to compensate is it deductible as compensation." Whether such intent has been demonstrated is a factual question to be decided on the basis of the particular facts and circumstances of the case. Aside from the fact that substantial services were performed, no other facts indicate that compensation was paid or was ever intended to be paid. The court stated that the fact that the brothers could have been paid compensation which would have been deductible does not establish that the distributions were intended as compensation. Thus the question comes down to the intent of the parties when the distributions were made, and not what might have been done. Accordingly, the court held that Paula was not able to deduct any of the amounts as compensations.

In *Automated Typesetting, Inc.*,⁴² the court found that a family-owned corporation was liable for income tax withholding and payroll taxes on payments to various family trusts. The case did not address the reasonableness of compensation but instead focused on whether or not an employer-employee relationship existed between the corporation and the grantors of the family trusts. Three members of the Blaser family transferred ownership of a successful typesetting business to family trusts in an attempt to divert payment for personal services provided to the corporation to the separate entities. The court's summary judgment found that an employer-employee relationship existed between the Blasers and the corporation and it could not be held that the Blasers' services were controlled by the corporation nor could it be contracted away. This determination was based on three factors.

First, the court held that the Blasers's services were controlled by the corporation, it directed not only the "what shall be done" but also the "how is shall be done" elements of their activities. Further, the court noted that the Blasers performed continuing, full-time services that were an integral part of the corporation's operations. Additionally, evidence indicated that the Blasers worked at the corporate office and that the actual payment of their wages was controlled by the corporation.

Second, the court cited Treas. Regs. §§ 31.3121(d)-1(b),⁴³ 31.3306(i)-1(e),⁴⁴ and 31.3401(c)-1(f),⁴⁵ which provide that, generally, an officer of a corporation is an employee of that corporation if more than minor services are provided for remuneration. The facts indicated clearly that the Blasers were officers of the corporation who received remuneration for their services. At issue was whether or not the services provided by the Blasers were more than minor. In making its determination, the

⁴² *Automated Typesetting, Inc. v. United States* 527 F. Supp. 515 (E.D. Wis. 1981).

⁴³ Treas. Reg. § 31.1321(d)-1(b) (1980).

⁴⁴ Treas. Reg. § 31.3306(i)-1(e) (1960).

⁴⁵ Treas. Reg. § 31.3401(c)-1(f) (1970).

court looked to the character of the services, the frequency of performance of the services, and the importance of the services to the corporation. The Blasers' services as officers were deemed substantial by the court because they (1) participated in hiring and firing decisions, assigned and supervised employees, purchased materials and procured business, and performed accounting and recordkeeping activities; (2) regularly worked 40 hours or more weekly; and (3) supervised and managed every aspect of the business. Therefore, as officers of the corporation who performed substantial services for remuneration, the Blasers were considered employees.

Third, the court held that the establishment of the family trusts was basically a ineffective scheme aimed at shifting the tax burden from the Blasers to the trusts. Therefore, the monies paid to the trusts by the corporation were deemed wages to the Blasers, and accordingly, were subject to withholding and payroll taxes.

In *Ulrich*,⁴⁶ the IRS successfully imposed approximately \$30,000 in unpaid employment taxes, penalties, and interest for the years 1980 to 1983 on an S corporation. This action of the IRS apparently resulted from a no change audit of the shareholder's individual tax return for 1977. The audit was completed in 1979. During this time period from 1974 through 1983, Ulrich, a CPA and sole shareholder of the S corporation in question, reported all monies received from the S corporation as distributions. As a result he was paid no salary for the years cited. Ulrich had concluded he was not an employee for the purpose of the statutes governing employment taxes, since he had no supervisors and set his own work schedule. He reached this conclusion even though he had spent considerable time working for the corporation during the period 1974-1983. Because Ulrich had provided more than minor services, he was deemed to be an employee of the corporation subject to federal employment taxes.

In *Radtke*,⁴⁷ an electing small business corporation, Joseph Radtke, S.C., paid no salary to its sole incorporator, director, shareholder, and officer under an employment contract. Radtke, an attorney and the corporation's only full-time employee, devoted all of his working time to providing legal services for the corporation's clients. The corporation complied with all applicable state laws in declaring and paying dividends to Radtke. In 1982 Radtke received \$18,225 in dividends. The court found that Radtke was the only significant employee of the corporation and that he provided substantial services. The court found it was only logical that a corporation be required to pay employment taxes when it employees an individual. It further stated that courts reviewing such cases were obligated to look at the substance, not the form, of the transactions at issue. It declared that the "dividends" were in substance "wages" and that an employer should not be allowed to evade payroll taxes by characterizing all of an employee's remuneration as something other

⁴⁶ C.D. Ulrich, Ltd. v. United States, 692 F.Supp. 1053 (D.Minn. 1988)

⁴⁷ J. Radtke, S.C. v. United States, 712 F. Supp. 143 (1989), *aff d.*, 895 F. 2d 1196 (7th Cir. 1990).

than “wages.”

Two additional cases *Usser*⁴⁸ and *Spicer Accounting*⁴⁹ were resolved by the courts in 1990. Fred R. Usser, P.C. was an S corporation formed by Usser to perform legal services. He was the sole shareholder, the president, and the only attorney employed by the corporation. Usser’s wife was the sole clerical employee. Neither Usser nor his wife was paid a salary, although the corporation “loaned” Usser money on almost a weekly basis. At the end of the year, Usser would declare a dividend in an amount equal to the corporation’s net taxable income. However, Usser would leave the dividends in the corporation to pay back the “loans” he had received during the year. For the year 1980, the Ussers reported \$49,487 as dividend income on their personal income tax return, but paid no taxes under FICA or FUTA. The IRS assessed deficiencies for the FICA and FUTA taxes. The District court held that Usser was an employee due to his substantial legal services to the corporation. Thus, the dividends to him were treated as wages.

Spicer was the president, treasurer, and director of Spicer Accounting, Inc., an accounting firm. In addition, he and his wife were the only shareholders of the S corporation. Spicer performed substantial services for the corporation and, in fact, was the corporation’s only accountant. He normally worked approximately 36 hours per week, expanding to a six-day week during tax season. Spicer was never paid a salary by the corporation, but “donated” his services to the corporation and withdrew earnings in the form of dividends. In 1985 the IRS made assessments against the corporation for FICA and FUTA taxes for 1981 and 1982. Spicer argued that he was an independent contractor, but the District court determined that he was an employee and that the “dividends” were wages subject to FICA and FUTA. On appeal, the Ninth Circuit emphasized that an employer should not be permitted to evade FICA and FUTA by characterizing compensation paid to its sole shareholder and director as dividends, rather than wages. Spicer was the only accountant working for the corporation, he performed substantial services on a continuing basis, and his services were integral to the operation of the firm. Spicer even acknowledged that he would have to pay a replacement \$16,000 to \$17,000 a year. Therefore, the court also rejected Spicer’s contention that he was an independent contractor, since the corporation provided him with supplies and a place to work, and he performed accounting services for no other accounting firm.

Lessons From the Losers

An employee’s qualifications are always considered in determining the reasonableness of such employee’s compensation. The courts may consider the educational, employment, and technical background of the employee as well as

⁴⁸ F.R. Usser, P.C. v. United States, 750 F. Supp. 421 (D. Ariz. 1990).

⁴⁹ Spicer Accounting, Inc. v. United States, 918 F. 2d 90 (9th Cir. 1990).

inventive abilities and managerial skills in determining if compensation is reasonable.⁵⁰ Presumably, the IRS and courts will hold that employees who are highly skilled or who possess special talents or abilities should receive greater compensation than employees lacking such skills or abilities. Therefore, in attempting to justify a smaller salary, it may be wise to downplay any special qualifications and portray the employee as an average worker.

In considering the employer's salary scale, the courts will likely make comparisons of the employee-shareholder's salary to the other employees of the business. Trends in salaries may also be considered.⁵¹ Where a significant disparity exists between the salaries of two or more employees, it may be difficult to establish that each employee's salary is reasonable. For example, if employees A and B perform similar functions and A is paid \$75,000 annually while B is paid only \$5,000 annually, the courts may rule that B's compensation is inadequate, based simply on a comparison of A's and B's salaries in light of their activities.

Because it is unlikely that a number of businesses in a particular industry will pay inadequate salaries to employees, the courts may consider the prevailing rates of compensation in the particular industry within which the S corporation operates. Here the taxpayer has the burden of proving the employee-shareholder's compensation is comparable to others in the same position in the same industry.⁵²

The size of the business and complexity of operations may be considered in ascertaining the reasonableness of compensation paid to shareholder-employees. Presumably, larger businesses engaging in somewhat complex operations would be required to pay larger salaries to shareholder-employees compared with smaller, less complex businesses. Size may be established by reference to the amount of annual revenue, gross profit, operating expenses, and net income as well as reported assets and net worth. The complexity of operations may depend on a number of factors including, but not limited to, the industry the business operates within, the nature and amount of business activities, and organizational structure.

In examining the ratio of compensation to business income, the courts appear to react to the trend of this ratio as much as the ratio itself. Further, the courts may consider the direction of compensation paid and income. The courts may likely consider compensation as inadequate where the amounts paid over time are decreasing while taxable income shows an increasing trend. On the other hand, decreasing salaries may be justified where they are accompanied by decreasing taxable income. An increase or decrease in services performed or responsibilities

⁵⁰ See *Griswold Rubber*, 34 T.C.M. 033 (1965).

⁵¹ See *Arizona Plating and Polishing v. Commissioner*, 51 T.C.M. 471 (1982); *Ken Miller Supply v. Commissioner*, 47 T.C.M. 228 (1978).

⁵² See *R. Guzowski v. Commissioner*, 36 T.C.M. 145 (1967).

undertaken in determining the reasonableness of compensation.⁵³

The contingent nature of the salary agreement and the date of determination of the compensation are factors that are closely related to the business' dividend policy. A salary agreement that is based upon profits may be viewed as a means of distributing profit; therefore, the distribution may be considered a dividend as opposed to compensation. If the date of determination of the compensation is made at the time an income statement is prepared, the courts may interpret the compensation as a dividend.⁵⁴ Therefore, the taxpayer's position that income should properly be characterized as dividends will likely be strengthened if the income is distributed at year-end rather than uniformly throughout the year in question.

General economic conditions may be considered in ascertaining whether compensation is reasonable. When the employee-shareholder's responsibilities or the value of services have not changed, the courts may interpret any change in profits as due to the general economic conditions. In such instances, an increase in compensation received may be considered a distribution of profits. However, a downturn in economic conditions may be a defense where the taxpayer is attempting to justify a decrease in compensation as a cost-containment or survival tactic.⁵⁵

Payment of a significant portion of profits as dividends may lead the courts to rule compensation is inadequate. However, a shareholder should be entitled to a reasonable rate of return on his investment, and, in this light, the taxpayer can argue that dividend consideration should at least be on an equal footing with salary consideration. In judging the reasonableness of dividends paid in the current year, the courts may look to prior years dividends paid and the corporation's need for reinvested profits.⁵⁶ The payment of dividends in lieu of salary may be partially justified by indicating a lack of need to reinvest the profits in the business. Table 1 summarizes the principal factors that support and those that refute lower levels of salary.

⁵³ See *B.B. Rider v. Commissioner*, 725 F. 2d 945 (1984) & *Home Interiors and Gifts v. Commissioner*, 73 T.C. 1142 (1980)

⁵⁴ See *supra* note 33.

⁵⁵ See *Kewaunee Engineering v. Commissioner*, 48 T.C.M. 154 (1979).

⁵⁶ See *R. L. Townsend v. Commissioner*, 49 T.C.M. 264 (1980); *Paramount Clothing v. Commissioner*, 48 T.C.M. 64 (1979); *Drexel Park Pharmacy v. Commissioner*, 48 T.C.M. 518 (1979); and *Good Chevrolet v. Commissioner*, 46 T.C.M. 2911 (1977).

TABLE 1

FACTORS SUPPORTING & REFUTING LOWER LEVELS OF SALARY

<u>FACTORS SUPPORTING LOWER LEVEL OF SALARY</u>	<u>FACTORS REFUTING LOWER LEVEL OF SALARY</u>
<i>Employee qualifications</i> normal qualifications; average work experience; general education/training; no technical skills	<i>Employee qualifications</i> unique qualifications; distinctive expertise; special training/education technical skills; extraordinary talent
<i>Nature, extent, scope of work</i> contributions minimal; non-executive/managerial position; business success not employee-related	<i>Nature, extent, scope of work</i> demanding work load/conditions; executive/managerial positions; business success attributable to employee
<i>Employer's salary scale</i> employee salaries comparable	<i>Employer's salary scale</i> salary significantly lower than other employees
<i>Industry Compensation rates</i> low salary normal for industry	<i>Industry Compensation rates</i> high salary normal for industry
<i>Size and complexity of business</i> small, simple operations; relaxed business environment.	<i>Size and complexity of business</i> large, complex operations; demanding business environment
<i>Compensation-to-income ratio</i> marginal profits or losses; profit trend declining	<i>Compensation-to-income ratio</i> significant profits; profit trend increasing
<i>Salary agreement and date of determination</i> salary fixed in advance; regular payments throughout the year	<i>Salary agreement and date of determination</i> salary paid at year-end; zero salary agreements
<i>General economic conditions</i> economic downturn; softening of general business conditions	<i>General economic conditions</i> good economic conditions; industry outlook favorable
<i>Prior compensation compared to dividends</i> current & previous salaries comparable; dividends paid when reinvestment of earnings not needed	<i>Prior compensation compared to dividends</i> Previous salaries significantly higher than current salary; significant dividends paid when reinvestment of earnings needed
<i>Time contributed</i> part-time employee; erratic work schedule; fluctuating working schedule; fluctuating working schedule; sporadic contributions	<i>Time contributed</i> full-time employee; fixed work schedule; ongoing and regular contributions

CONCLUSION

The increasing payroll tax burden is likely to fuel the inadequate compensation issue. Proper tax planning should be beneficial for S corporations interested in minimizing the FICA and FUTA tax.

Where each employee-shareholder's salary equals or exceeds \$125,000, there would be no risk of attack by the IRS, at least from an inadequate compensation perspective, because the maximum amount of social security taxes would be paid. However, it would be injudicious to establish salary levels based solely upon a consideration of tax consequences. Instead, S corporation employee-shareholders should attempt to establish the reasonableness of compensation, in light of the factors discussed above. Then, if it appears that a certain compensation plan could possibly be construed by the IRS and courts as unreasonable, an evaluation of potential risk exposure should be undertaken and, if necessary, a change in the nature, timing, and (or) extent of compensation may be in order. As mentioned earlier, it appears that in determining how small a salary may be and still be considered reasonable, the courts will probably refer to the same factors that have previously been referred to in resolving excessive compensation cases. However, the taxpayer is advised to avoid making any generalizations concerning the factors that influence the court's interpretation of reasonable compensation without also acting judiciously when establishing the amount and character of shareholder-employee compensation.

