The Other Side of the "Reasonable Compensation" Coin

By Robert W. Wood • Wood & Porter • San Francisco

Every so often, long-established tax incentives are turned on their heads. Depending on your identity and circumstances, you may find yourself arguing that a distribution is a dividend, or that the same distribution is *not* a dividend.

When you utter the terms "reasonable compensation," you automatically suggest the context. This not-meant-to-be-an-oxymoron phrase almost invariably conjures up the notion of a business seeking to deduct payments made to officers, directors and/or shareholders. Increasingly, however, this phrase suggests the kind of duality suggested by many other dichotomies in our tax law.

Closely Hold

First, one must draw a line between closely held and public companies. Public ones face the gauntlet of Code Sec. 162(m) and its $1 million deductible compensation limit, while privately held companies face a more amorphous test. In fact, if you even utter the phrase "reasonable compensation" you are almost always tipping your hand to reveal a closely held company.

Of course, what is reasonable today and what was reasonable 30 years ago are very different things. In fact, it does not seem overly cynical to suggest that virtually anything is reasonable in what so many have labeled as our post–Gordon Gekko climate. Notwithstanding recent Wall Street bailouts, today, huge compensation packages for services rendered hardly seem to raise an eyebrow. The pay packages are so huge that some recipients can waive their pay for a year or two and should be fine.

Nevertheless, the fundamental tax principles haven't changed, and closely held companies are required—at least occasionally—to demonstrate that something paid out as compensation is *really* qualified to be treated as such. The deduction at the corporate level (for a C corporation) is worth a lot, even if payroll taxes have to paid. But what of flow-through entities?

In this prevailing age of closely held flow-through entities (including partnerships, LLCs and S corporations), it may seem especially attractive not to need corporate tax deductions, and yet also not to need to pay payroll taxes. The prevalence of flow-through entities since 1986 is precisely the reason there is such a paucity of reasonable compensation tax cases these days, along with the notion that just about any outsize compensation is reasonable today. In the S corporation context, for example, what's wrong with having the S corporation distribute all "profits" as a dividend to a sole shareholder, and not paying *any* compensation that would be subject to payroll taxes?

Don't Get Greedy

What's wrong with that picture, of course, is precisely that the S corporation has not paid any payroll taxes. Early case law established that the IRS could attribute reasonable compensation where none was paid. This is kind of a reverse reasonable compensation problem.

The IRS would essentially say that the corporation *should* have paid amounts as compensation rather than as dividends. Much of the early case law on this topic dealt with egregious situations in which it was clear that services were being rendered (in some cases by a sole shareholder employee), and yet not one penny of compensation was paid and subject to payroll taxes. [*See Spicer Accounting*, CA-9, 91-1 USTC ¶50,103, 918 F2d 90 (1990). *See also J. Radtke*, DC-WI, 89-2 USTC ¶9466, 712 FSupp 143 (1989), *aff'd*, CA-7, 90-1 USTC ¶50,113, 895 F2d 1196 (1990).]

After such early authority with such an obvious outcome, slightly more creatively, taxpayers began bifurcating payments. Some planners had the S corporation pay out a relatively small amount for services rendered, with much of the corporate income passed through to the sole (or the handful of) closely held shareholders as dividends. This strategy achieved national prominence with none other than John Edwards.

Edwards' Vetted

Senator Edwards may be best remembered for his recent Rielle Hunter videographer scandal, and his hiding in the Beverly Hilton Hotel after visiting "someone else's" love child. Nevertheless, less juicily, a few years ago Senator Edwards' S corporation machinations caused at least some ripple in the tax community. A very successful plaintiffs' lawyer, Edwards apparently had significant income in his S corporation legal practice vehicle.

He reportedly paid himself a relatively modest salary of $360,000 (on which payroll taxes were duly paid). He distributed the vast bulk of the income (about $26 million) as a dividend distribution, a flow-through of S corporation profits. The colloquy in the tax press at the time generally concluded that it was largely a factual question how much compensation was "reasonable." Some portion of the income Edwards received was surely allocable to his *own* legal services, and some was surely attributable to his ownership of (and capital invested in) the firm. But how much?

The press at the time suggested that it would probably be hard for the IRS to show that the amounts Edwards had the corporation distribute to himself as "dividends" were actually disguised compensation. Interestingly, management services rendered by Edwards, like legal services, would surely have to go into the compensation bucket, but it does not appear that anyone was so arguing.

New Facts

The IRS seems always to be coming out with new and different nomenclature for news releases, notices and other miscellaneous guidance. In the endless march of information, there are new and different tidbits. Soon, the IRS may even twitter. In any case, until recently, I hadn't heard of an IRS "Fact Sheet."

Fact Sheet 2008-25 provides information on just this issue, earmarking the topic for S corporations and their owners. What is the proper tax treatment when corporate officers perform services for the entity? The fact sheet warns S corporations not to attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses and/or loans rather than wages. It goes on to state that the fact that an officer is also a shareholder does not change the requirement that payments to that officer should be treated as wages. Pay is pay.

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The IRS stresses that the courts have "consistently" held that S corporation officers/shareholders who provide more then minor services to the company and receive (or are entitled to receive) payment are employees. That means their compensation is subject to federal employment taxes. [*See Yeagle Drywall Co., Inc.*, CA-3 2002 (54. Fed. Appx. 100 (2002), *cert. denied*, 539 US 943 (2003). *See also Nu-Look Design, Inc.*, CA-3, 2004-1 USTC ¶50,138, 356 F3d 290 (2004).]

How Much Is Reasonable?

Traditional reasonable compensation tax cases don't seem to come along too often these days. By "traditional reasonable compensation cases," I mean cases in which the taxpayer is arguing the company can deduct a whopping payment because it is reasonable compensation for services rendered. Yet, the reverse variety of reasonable compensation case seems to be hatching more and more.

IRS Fact Sheet 2008-25 may be intended to scare small business into paying ALL amounts out as compensation. Plainly, such a reaction would be overbroad. In fact, the Fact Sheet itself states that distributions and other payments by the S corporation to officers must be treated as wages "to the extent the amounts are reasonable compensation for services rendered to the corporation."

The question, of course, is just what constitutes reasonable compensation. There's the conundrum again. The taxpayer will obviously have an incentive to err on the low side of reasonable (compared to the old days in a C corporation context, where the taxpayer had an incentive to err on the *high* side of reasonable). But within this vast frontier, how does one set it?

The Fact Sheet acknowledges that there are really no specific guidelines for what constitutes reasonable compensation (viewed from either perspective!!) in the Code or Regulations. This requires nitty-gritty factual analysis. With a kind of throw-it-at-the-towel resignation, Fact Sheet 2008-25 simply lists a variety of factors that the courts have considered in determining what is reasonable. These include the following:

- Training and experience
- Duties and responsibilities
- Dividend history
- Time and effort devoted to the business
- Payments to non-shareholder employees
- The timing and manner of paying bonuses to keep personnel
- Compensation agreements
- The amount comparable businesses pay for similar services
- Using a formula to determine compensation

Conclusion

What is reasonable is unlikely to be the subject of universal agreement. There will usually be subjective criteria, and it sometimes seems that virtually anything is reasonable to someone. That suggests this area, like disputes among appraisal specialists over valuation matters, may come down to a battle of the experts.

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