Discerning Compensation From Dividends in Professional Firms

By Robert W. Wood

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The dichotomy between compensation for services and dividends and profits never seems to disappoint. Wood examines Judge Richard Posner's opinion in *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, seeking to reconcile it with the larger C corporation versus S corporation compensation question.

We are fascinated by cases distinguishing compensation for services from dividend and profit distributions. Why are these cases so intriguing? One reason is that personal service professionals, including lawyers and accountants, are apt to study them out of self-interest. Another is the lack of bright lines that make this both maddening and flexible in equal measure. Another is the unease we feel at imagining our own structure up on display under hot lights.

Recently I addressed unreasonably low S corporation pay[1] and how the IRS, courts, and practitioners are responding to this problem. Apart from cases involving mere mortals, this topic is replete with examples from the tax playbooks of Newt Gingrich and John Edwards. That makes them fun. Because of the payroll issue and the S corporation structure (which is surely more prevalent than C corporations for services today), the stakes can be high.

There is now another new case reporting on yet another professional services firm mishap: *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*,[2] in which Judge Richard A. Posner wrote an opinion for the Seventh Circuit. It involves the dividend versus compensation divide, although it examines the flip side of the question. It is an important case that merits attention, shedding light on both sides of the equation.

With S corporations, the question is what must be paid out as compensation subject to payroll taxes and what can simply be passed through as profit. The incentive is to pay minimal compensation and therefore minimal payroll taxes. The IRS will want to assert that the dividend was really payment for services.

For C corporations, of course, the incentives are flipped. The question is what can be deducted as reasonable compensation for services rendered. Although compensation is subject to payroll taxes, having money taxed at the corporate level and then taxed as a dividend results in higher taxes. In each context, deciding how much is enough or too much is more difficult than you might think. Plus, it may be harder today than it was in the past.

When the owners of the personal service business are paid, in what capacity are they being paid? Labels count, but labels alone aren't enough. The organizational question, C corporation or S corporation (or limited liability company or limited liability partnership), will determine incentives, although in each case the same ox is being gored.

Accounting Firm Mishap

In *Mulcahy, Pauritsch, Salvador & Co.*, an accounting firm engaged in the understandable splitting of payments to its owners. Some was pay and some was a dividend. The question was whether the amount paid as compensation and so treated for tax purposes was reasonable. Put differently, the question was whether amounts that were treated as

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[1] *See* Robert W. Wood and Christopher A. Karachale, "Unreasonably Low S Corporation Pay," *Tax Notes*, May 14, 2012, p. 893, *Doc 2012-7951*, or *2012 TNT 96-10*.

[2] No. 11-2105 (7th Cir. 2012), *Doc 2012-10610*, *2012 TNT 97-18*.

consulting fees to related entities and deducted were really disguised dividends.

As usual, Posner was concise and perceptive. He laid out the patent tax incentives and the fundamental difference between taxable C corporations and flow-through entities such as S corporations. Of course, reasonable compensation for services is deductible, while dividend distributions are not.

Noting that there are differences between professional service firms with one employee-owner and larger firms with many employee-owners and with more capital, Posner made clear that this case involved the latter. In fact, this accounting firm had the physical capital to support 40 employees in multiple offices. It had capital, client lists, and brand equity.

Regardless of firm size, employee-owners have an incentive to treat dividends as salary. Courts sometimes must recast payments the other way. Invariably these cases involve closely held companies.[3]

Doing business as a C corporation — which Posner said was puzzling for a bunch of accountants — the firm claimed it had little income and therefore owed little corporate tax. A whopping $5 million to $7 million a year in revenue was offset with deductions. The biggest item was compensation paid to the three employee-owners who founded the firm.

Edward Mulcahy, Michael Pauritsch, and Philip Salvador together owned more than 80 percent of the stock. They received salaries totaling $323,076 in one year — a year the firm reported taxable income of only $11,279. The next year the firm reported a loss of $53,271 and zero taxable income the third year.

The IRS allowed the salary deductions, but the three founders got most of their ''pay'' — more than $850,000 each year — through purported consulting fees. The firm paid three entities owned by the founding shareholders, and those entities passed the money to the founders. It was those fees that the IRS and the Tax Court reclassified as dividends, asking for additional taxes from the corporation for all three years.

Penalties were also added. Although relying on professionals can normally obviate penalties, the three founding accountants were relying on themselves. Compared with independent professional advice, this do-it-yourself version paled by comparison.

Independent Investors?

How does one separate pay from dividends? The IRS, Tax Court, and Seventh Circuit all rejected the firm's argument that the consulting fees were deductible as salary. After all, those payments reduced the firm's income — and thus the equity return to the founders as investors — to zero or below. In all three years, the founders were doing just fine, but the firm was losing money.

As Posner put it pithily, ''the firm flunks the independent-investor test.''[4] The firm argued that Illinois limits equity investments to an accounting firm's active participants.[5] But just because only active accountants could contribute capital does not mean there should be no return on it, said the court. The firm had significant tangible and intangible capital. Any investor would expect *some* return.

The firm then argued that the consulting fees paid to the related entities were not for services rendered to the firm by the related entities but were actually disguised payments to the founders for services. Yikes, you are probably thinking. That claim contradicted the tax returns, a fact that Posner didn't like, and there was no evidence to support it.

Besides, Posner noted, why conceal this putative compensation via a two-step through related entities? The founders were paid indirectly, the firm argued, not because of the obvious tax incentives. Rather, the firm did this to hide from the other employees just how much the founders were receiving. That argument failed, too.

Similar Companies?

What tools define this mess? One test compares the corporation's reported income with similar corporations. This may be stated in a percentage return on equity, a standard measure of corporate profitability.[6] The higher the return, the stronger the evidence that the employee-owner deserves a high salary. In fact, salary paid to an employee-owner is presumptively reasonable if the firm generates a higher return on equity than its peers.[7]

An investor won't begrudge the employee-owner a high salary if the equity return is satisfactory. But the presumption is rebuttable. After all, in some cases the company's success may be the result

[3]*See, e.g., Menard Inc. v. Commissioner*, 560 F.3d 620, 621-622 (7th Cir. 2009), *Doc 2009-5325*, *2009 TNT 46-9*; *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 834 (7th Cir. 1999), *Doc 1999-36657*, *1999 TNT 222-6*; *Haffner's Service Stations Inc. v. Commissioner*, 326 F.3d 1, 3 (1st Cir. 2003), *Doc 2003-8201*, *2003 TNT 63-17*; *Eberl's Claim Service Inc. v. Commissioner*, 249 F.3d 994, 996 (10th Cir. 2001), *Doc 2001-12982*, *2001 TNT 89-11*; *LabelGraphics Inc. v. Commissioner*, 221 F.3d 1091, 1095 (9th Cir. 2000), *Doc 2000-21055*, *2000 TNT 155-10*.

[4]*Mulcahy, Pauritsch, Salvador & Co.*, No. 11-2105, slip op. at 8.

[5]*See* 225 Ill. Comp. Stat. 450/14.3(a).

[6]*See, e.g., Menard*, 560 F.3d at 623-624.

[7]*See Exacto Spring*, 196 F.3d at 839; *see also Menard*, 560 F.3d at 623.

of extraneous factors, such as an unexpected discovery of oil under the company's land.[8]

Comparable Salaries

What if the employee-owner's salary is close to salaries of comparable employees who are *not* owners? Then it's likely the compensation was not a concealed dividend. But what if, as in typical small professional services firms, the firm's *only* business is services rendered by its employee-owners?

What if there are no other employees except a secretary, and only trivial assets — a rented office and some office equipment? The employee-owners' income from rendering personal services is almost identical to the firm's income. In that case, the company is what Posner called "a pane of glass," with transparent billings and revenues.

If the capital in the business is negligible, one need not distinguish a return on capital from a return on labor. Posner noted that today most professional services firms are LLCs, LLPs, limited partnerships, or S corporations. The obvious reason is to allow income to pass directly to the owners and be taxed to them.

The firm even argued that the consulting fees could not have been dividends because they were allocated among the founders in proportion to the number of hours that each worked. But if the fees were paid out of corporate income, every compensated hour included a capital return, according to the court. Posner went as far as to say that a corporation can't avoid tax by "using a cockeyed method of distributing profits to its owners."[9]

In one of the judge's best zingers, he said:

> Remarkably, the firm's lawyers (an accounting firm's lawyers) appear not to understand the difference between compensation for services and compensation for capital, as when their reply brief states that the founding shareholders, because they "left funds in the taxpayer over the years to fund working capital," "deserved more in compensation to take that fact into account." True — but the "more" they "deserved" was not compensation "for personal services actually rendered." Contributing capital is not a personal service. Had the founding shareholders lent capital to the company, as it appears they did, they could charge interest and the interest would be deductible by the corporation. They charged no interest.[10]

The firm argued that the value of the firm, like other professional services corporations, was its annual gross revenues. The contribution the founding shareholders made to the firm's value might be reflected in annual changes to those revenues. But that ignores the firm's costs, which might be growing in tandem.

The firm put on an expert witness, Marc Rosenberg, who testified that the founding shareholders' pay was comparable to that earned by accountant-owners of comparable accounting firms. Posner, however, called that testimony irrelevant and said it should not have been allowed.[11] Rosenberg acknowledged he hadn't tried to estimate the value of the personal services, and to Posner that was fatal. The expert examined only firm income per partner, which did not even attempt to distinguish compensation for personal services from dividend components.

To Posner, this firm should not have operated as a C corporation and sought to avoid double taxation by overstating deductions. Reorganizing as a passthrough entity would have achieved the same result and avoided legal challenge, he said. Those accountants were hoist by their own petard, and the court wasn't going to undo their mess.[12]

Conclusion

The Seventh Circuit agreed with the IRS about disallowing the deduction of the consulting fees. The court also agreed that imposing the 20 percent penalty was correct. The case is fact-specific and it hardly changes the landscape. Yet, to return to the choice of entity question of C corporation versus S corporation, does this case help?

It may. Some S corporations may find that this particular cloud contains a silver lining. They may suggest that the case supports paying small salaries and bonuses and having much of the income distributed as dividends. But even if that's true, documentation and reasonableness are key. Of course, the IRS is likely to view this case as primarily about return on investment. As is so often true for both taxpayers and the IRS, much comes down to perspective.

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[8] *See Menard*, 560 F.3d at 623.

[9] *Mulcahy, Pauritsch, Salvador & Co.*, No. 11-2105, slip op. at 10.

[10] *Id.*

[11] *See ATA Airlines Inc. v. Federal Express Corp.*, 665 F.3d 882, 896 (7th Cir. 2011).

[12] *See Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974).