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IRS Win Contains Taxpayer Victory on Reasonable Compensation

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Since the Tax Reform Act of 1986 few closely held businesses have been structured as C corporations.

The initial preference was for S corporations. Why? A disallowed corporate expense, e.g., the shareholder-employee's dinner with the spouse, would create income to the shareholder (a dividend), but would not create a second level of tax (for the corporation).

More important, a disposition of the business by means of an asset sale would not result in two layers of tax. Once limited liability companies started to proliferate (California enacted LLC legislation in 1996), some closely held businesses chose that structure.

However, C corporations will be getting a closer look in 2013 and beyond. The fact that the first $25,000 of corporate taxable income is taxed at 15 percent and the next $50,000 is taxed at 25 percent is increasingly attractive when the top individual tax rate has climbed to 39.6 percent (especially in states with high individual tax rates, e.g., California at 13.3 percent).

One of the traditional problems with a C corporation is "reasonable compensation." The basic idea is that if the corporation pays "too much" compensation to the shareholder-employee, the IRS will argue that a portion of the compensation is really a dividend. This is the so-called "disguised dividend" theory. The disallowed compensation will, as a result, still be taxable to the shareholder-employee, but not deductible by the corporation, creating a corporate-level tax.

Example: Joe owns Joe's Painting, Inc., a C corporation. Joe has invested $500,000 in the corporation in the form of equipment and working capital. Joe works long hours, manages many employees, handles the marketing, bookkeeping and all other management responsibilities, and receives, as an employee, a salary of $600,000.

However, the corporation does not pay him a dividend, so he is receiving nothing as a return on his invested capital. The IRS challenges Joe's $600,000 of compensation as "unreasonable." The IRS proposes to disallow $100,000 of it and recharacterize it as a dividend. If the IRS prevails, Joe will still have the entire $600,000 of personal taxable income, but the corporation will have $100,000 of taxable income. Joe obviously does not want his corporation to be liable for that tax. What might he have done differently? The corporation should declare a dividend each year that constitutes some reasonable return on invested capital. There is no magic formula. On these facts $25,000 would be a nice number ($50,000 would be even better). A written employment agreement spelling out Joe's duties, and the compensation formula would also help. This example is not intended to be exhaustive. It is simply an introduction to the analysis required by those of us who counsel closely held businesses.

In **K&K Veterinary Supply, Inc. v. Commissioner**, T.C. Memo 2013-84 (March 25, 2013), a large, profitable, closely held business was run by John Lipsmeyer, his brother, wife and daughter. For the two years at issue—2007 and 2006—the corporation had sales of $66 million and $60 million; gross profit of $9,700,000 (both years); and taxable income of $128,000 and $42,000. Also, the corporation paid Mr. Lipsmeyer a $30,000 dividend each year.

Of course the issue in the case was whether the compensation paid to the four family members was "too much." However, at the outset, there was an unusual fact: the IRS did not challenge Mr. Lipsmeyer's 2007 compensation, the highest figure of all. Following is a chart comparing the compensation for each of the four for both years, with the figures determined reasonable by the IRS's expert:

	2007 Taxpayer	2007 IRS	2006 Taxpayer	2006 IRS
Husband	$981,728	$732,300	$746,229	$559,100
Wife	$215,000	$134,400	$198,000	$133,500
Brother	$922,853	$590,500	$735,029	$470,000
Daughter	$287,528	$183,000	$287,429	$192,700
Total	$2,407,109	$1,640,200	$1,966,687	$1,355,300

Former Tax Court Chief Judge Mary Ann Cohen first examined the facts using the criteria normally applied in reasonable compensation cases: employee qualifications; nature, extent and scope of employee's work; size and complexity of the business; general economic conditions; comparison of salaries paid with gross and net income; prevailing rates of compensation for those in similar positions in comparable companies within the same industry; the taxpayer's salary policy for all employees; previous years' compensation; comparison of salaries with distributions and retained earnings; and whether the employees guaranteed corporate debt.

Mrs. Lipsmeyer (the wife) unhelpfully testified that it was "very hard for me to say what exactly I was doing other than the obvious, which was helping with, you know, like the financial decisions. ... Well, [I] just have conversations naturally with my husband about, you know, what was going on with the business..." With that type of testimony it is not difficult to see why Mrs. Lipsmeyer's compensation suffered the largest percentage reduction. The taxpayer was also, however, unable to establish that Mr. Lipsmeyer and his brother were "exceptionally qualified or that either was the primary reason for petitioner's growth." The evidence indicated that the daughter's value "falls short of establishing that she was exceptionally qualified or the primary reason for petitioner's growth."

Despite those shortcomings, the taxpayer's primary problem was in the battle of experts, which was not a battle but a rout. The taxpayer's expert failed to identify companies within an industry comparable to K&K Veterinary; failed to establish that the companies in his samples were of a size comparable to K&K Veterinary; and failed to provide financial data such as gross receipts or sales, net income, or capital value.

As a result Judge Cohen dismissed his report completely. Instead, she relied on the IRS's expert, who identified 12 publicly listed companies engaged in comparable industries. He presented financial data for each company and determined the amounts of reasonable compensation based on a correlation between annual sales/revenues and fixed compensation as demonstrated by application of the linear regression statistical technique.