

## **Unreasonable Compensation to PC Shareholders The IRS Gains a Victory**

by

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The general view has been that unreasonable compensation claims against shareholder employees of professional corporations was not an issue. In *Pediatric Surgical Associates P.C. v. Commissioner*<sup>1</sup>, the tax court determined that compensation paid to the shareholder physicians was unreasonably high because it exceeded the value of the services performed by the shareholder physicians. Many law firm professional corporations could face this same issue.

### **Professional Corporation Background**

Professional corporations have been around for over 30 years. Their importance largely grew out of favorable tax benefits (particularly the then immense differences between qualified retirement programs for incorporated businesses and those available for unincorporated businesses) and limited liability (both general liability and liability arising out of the malpractice of other shareholder-employees or professional employees not under your supervision). In the early 1980s the tax reasons largely disappeared when the rules for corporate and self-employed pensions were placed on equal status. Later that decade, the tax planning advantages of different tax years largely disappeared. Finally, the adoption of professional limited liability partnerships and professional limited liability companies offered attractive alternatives to the professional corporation.

Those changes did not immediately halt the growth of professional corporations. Habit, set thinking patterns, comfort with established precedents and concern for untested forms of organization contributed to further creation of new professional corporations. In addition, many existing professional corporations continue to operate in that form for several reasons — there is no compelling reason to change to one of the more flexible forms of organization; minor, but popular tax benefits remain (at least for “C” corporations); and undoing the corporate decision without unintended tax consequences is a bit tricky.

Professional corporations have encountered difficulty when the shareholders have not operated the business consistent with the formalities of a corporation. It is not sufficient to create the minimum legal filings and then go about business as usual. It is possible for not only the IRS, but also claimants, to pierce the corporate veil and remove either tax benefits or limited liability protection. But generally when the professional corporation is legitimately established and operated the tax and legal benefits accrue. The protocols are not onerous once reasonably diligent routines are established.

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<sup>1</sup> T.C. Memorandum 2001-81.

## Compensation Background

Compensation is deductible for a corporation if it is ordinary and necessary, paid or incurred during the year, for personal services rendered, and reasonable. Professional corporations generally have no trouble with meeting these tests.

However, a typical compensation problem for professional corporations is a carry over from traditional partnership operations — aligning compensation and ownership. The IRS generally views distribution allocations that mirror relative ownership to be dividends and not compensation. The result is the imposition of a corporate level income tax that is added to the individual income tax (double taxation).

Setting aside the rules applicable to publicly traded corporations, unreasonable compensation issues are more common for shareholder-employees of closely held corporations because there is rarely independence between the making of executive compensation decisions and those receiving the compensation. There are generally five factors that are considered in determining reasonable compensation.

The first is the nature and financial condition of the business. Does this business have growing revenues and profits? Are its financial ratios in good order or improving? Is this business performing better than its competitors? Is the business complex, unique, or highly specialized? Is the industry highly competitive?

The second are the roles of the shareholder-employees. Do these individuals have unique skills or knowledge? Have they innovated? How difficult is it to replace their contributions? Can you clearly demonstrate the contributions they made to the success of the business? Do they take on many roles (CEO, CFO, Marketing, etc)? What level of commitment is required in terms of hours? How do the compensation and individual roles compare with other similar businesses?

Third, the level of consistency in how compensation is set within the business. Are there documented compensation policies? Are they followed over time? Are the compensation arrangements for other employees (particularly similarly situated non-shareholder employees) comparable?

The fourth factor covers compensation paid for prior years work. Was there a timely executed agreement covering the deferred compensation? Was it reasonable? Was the compensation paid in the prior years less than it should have been? Can you demonstrate reasonable due diligence in determining the amount of the underpayment?

Finally, there is the independent investor test. Would an independent financial investor be willing to pay that compensation? Is the return on the equity investment, after paying such compensation, sufficient to attract and retain an independent investor?

Professional corporations primarily do one thing. They provide services that are largely the direct result of the personal services rendered by the professionals. It has been logical to then conclude that the net earnings of the professional corporation represent reasonable compensation to those professionals. This holds even for large compensation amounts as seen in Richard Ashare, P.C. v. Commissioner<sup>2</sup> where “a lawyer was the sole shareholder and professional employee in a law firm that devoted itself to a single class action and won a \$12.6 million contingent fee from a 1989 settlement. The fee was paid in 1989-92, and the P.C. paid out the fee as compensation, including \$1.75 million in 1993, long after the lawyer ceased performing substantial services. Still, the Tax Court acknowledged that all of the compensation was reasonable, because the shareholder’s personal services had earned the fee.”<sup>3</sup>

The concept that the net earnings of a practice represent reasonable compensation is further supported in Bianchi v. Commissioner. The Tax Court “held that is proper to examine the prior self employment earnings of a corporate employee to determine whether compensation currently paid to such employee is reasonable. In Bianchi, the corporate employee, a dentist, had incorporated his individual proprietorship, transferring to the corporation (which elected status as an S corporation) the equipment previously used in the proprietorship, accounts receivable and good will....In determining what would be reasonable compensation for his services provided to the corporation, [the Tax Court] said: “It cannot be questioned that the clearest evidence of the worth of the petitioner’s services is petitioner’s earnings from his dentistry practice as an individual proprietor.” ...It is clear that, in referring to “petitioner’s earnings”, [the Tax Court was] referring to the profit earned by the dentist as an individual proprietor. Indeed, [the Tax Court] restated [their] point as follows: “[T]he best evidence of the value of his personal services is profit he derived from his own practice.”...Undoubtedly, [the Tax Court was] using the term “profit” to refer to the excess of the dentist’s receipts from his practice of dentistry over the costs of earning those receipts but without any reduction for the value of the dentist’s own services.”<sup>4</sup>

Richard Ashare and Bianchi establish a rational framework for reasonable compensation in professional practices. Pediatric Associates is a logical next step for the IRS and one that, quite frankly, might have been taken years ago.

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<sup>2</sup> T.C. Memorandum 1999-282.

<sup>3</sup> Page 13-11, Tax Planning for Corporations and Shareholders, Second Edition, Zolman Cavitch, LEXIS Publishing, 2001.

<sup>4</sup> Pages 20 and 21, T.C. Memorandum 2001-81.

## **The Pediatric Associates Case**

The professional corporation provides pediatric surgical services. It employs shareholder and non-shareholder surgeons. This is a Texas personal service corporation. The IRS disallowed portions of the officer's compensation expense and reallocated it to dividends, subject to double taxation. They (the IRS) also applied the accuracy-related penalty<sup>5</sup> to the returns for the years under audit.

This case turned on the issue of profits generated by the non-shareholder surgeons. The Tax Court itself determined the amount of profits generated by the non-shareholder surgeons. Collection records were inadequate to clearly determine an appropriate allocation. The parties stipulated to one non-shareholder's collections and the Tax Court used a percentage of the net billings for the other non-shareholder surgeon.

Expenses for non-shareholder employees consisted of salary<sup>6</sup> and an allocation of overhead. The Tax Court looked to the employment contracts to guide its reasoning as to what expenses were or were not apportionable. Rent and other costs relating to the operation of the practice were included. Shareholder automobile expenses were excluded. The Tax Court then applied the parties' allocation methodology of apportioning such expenses on an equal basis among the surgeon employees based on the number of months they were employed during the year.

The net profits<sup>7</sup> of the non-shareholder employees constitute the unreasonable compensation. The Tax Court held "that the deductions claimed by petitioner for 1994 and 1995 for salaries paid to the shareholder surgeons exceed reasonable allowances for services actually rendered by them....and that such amounts, therefore, are not deductible by petitioner..."<sup>8</sup> The Tax Court also affirmed the accuracy-related penalty. "It is the shareholder surgeons' utter indifference to the possibility that a portion of the annual prebonus profits might have been derived from collections generated by non-shareholder surgeons that justifies respondent's imposition of the accuracy-related penalty in this case."<sup>9</sup>

### **Summary**

Many law firm professional corporations could face this same issue. What are the options available to owners of professional corporations in such a case? One strategy is to elect S corporation status. Professional corporations with a single class of

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<sup>5</sup> The accuracy-related penalty is 20% of any portion of a tax underpayment attributable to **(a)** negligence or disregard of rules or regulations, **(b)** substantial understatement of income tax, or **(c)** other misconduct with regard to asset valuation or pension liability overstatement. IRS instructions to Form 8275.

<sup>6</sup> The non-shareholder employee surgeons had employment contracts. There were no provisions for bonuses for these employees.

<sup>7</sup> The collections as determined less the expenses as determined on the personal services of the non-shareholder employees.

<sup>8</sup> Page 31, T.C. Memorandum 2001-81.

<sup>9</sup> Page 34, T.C. Memorandum 2001-81.

stock and 75 or fewer shareholders will generally qualify. However, more-than-2%-shareholders in an S corporation are taxed on fringe benefits as if they are self-employed partners rather than employees. An alternative is to seriously consider undertaking the conversion from a professional corporation to a professional limited liability partnership or a professional limited liability company. No matter the course selected, you should consult with your tax advisors about this new development.