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Problems Relative to Compensation

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PROBLEMS RELATIVE TO COMPENSATION

MR. LURIE:

Good morning. I don't know whether I'm more happy to be here this morning sharing a platform with two old friends of mine, Carr Ferguson and Merv Wilf, or a friend of Judge Powell's. Carr and I share Cornell, each with a double degree. That place must breed informality. He took his jacket off. I'm going to open my vest.

Merv's remarks recall to me the old Mack Sennett Comedies. I think a verity for any comedy is our tendency to laugh at other people's misery. You notice that Merv's biggest laugh this morning came when he spoke about the 23 months' of income he was suffering in one taxable year. I'm inclined to think we will probably be laughing at the misery of some professional corporations, or the shareholder-employees of professional corporations, who thought that they could take reasonable compensation, and found to their surprise that what they thought was reasonable or compensation was neither of those things.

I think that is, at least, the principal threshold problem in the professional corporation area. You can talk about sections 269 and 482, but to me the problem that is stopping more professionals in my backwards state of New York, which as Carr says has only recently come into the professional corporation era, is the worry about what is allowable compensation for the stockholder-employees.

Perhaps I'm over reacting; but the *McCandless*[1] case, which Carr mentioned lightly as a backwards approach, is, to me, a very upside-down kind of a case. Maybe I should take a lesson from my young son, who seems at the age of eight to be more philosophical than I. Recently I had occasion to yank him up by the heels as he was watching a television program. This didn't disturb him. He continued to watch the program, and as a Pillsbury Cake commercial was flashed on the screen, he said "Oh look, and upsidedown cake." Perhaps the *McCandless* case is just an upsidedown case, and I should take it with no more dismay than my son took my sudden upturning of his view of the cake commercial. But I'm inclined to take it somewhat more seriously. I think it's a very serious case.

The regulations dealing with compensation, typical regulations that apply to all corporations and all compensation, ask only that the compensation satisfy two tests: one, that it be reasonable, and, two, that the payment actually be intended as compensation. The cases have apparently accepted the view that even a reasonable amount won't be allowable if it's not really paid as compensation for personal services, and that an amount, even though intended as compensation, the court having no quarrel with the form of the transaction or the bona fide intentions of the parties, may nevertheless not stand as compen-

[1] Charles McCandless Tile Service v. U.S., 422 F.2d 1336 (1970).

sation where a reasonable return on capital has not been provided. That is now called, among lawyers that love to coin simple terms for complex things, the "automatic dividend" rule.

It is important to note that this particular case (*McCandless*) was not, as I read it, even a case involving personal services. *McCandless*, which was decided by the Court of Claims a couple years ago, involved a tile contracting firm. There the court found that the salaries paid to the principals who were shareholder-employees and who had developed the business (I think it was a father and son) were not only reasonable, they were actually below the national norms for compensation for executives in this type of contracting business; and the court found that it was therefore a completely reasonable salary. But what the court said in that case is that even a reasonable payment may not be deductible to the extent it's really a distribution of earnings.

I think a quote from the case itself is perhaps the most vivid demonstration of how far the court did go when it said: "The absence of a return on capital is conspicuous and indicative that the purported compensation payments necessarily contain a distribution of corporate earnings therein."

Now Carr has said that this might be a modest price to pay for the privilege of enjoying the so-called goodies of incorporation if you're at the 22% corporate bracket. But I submit to you that many law firms and other professional concerns that will be considering this problem may very well have a million dollars of earnings, that is to say after they have paid all of the overheads. And if they applied the *McCandless* test (*McCandless*, without offering any rationale for its mathematics, said that the appropriate return on capital that would be imputed to the shareholder-employee was 15% of the net profits, without any reference to actually how much capital was invested) then even though they were to follow Carr's advice of 'think thin' and 'keep lean,' (that obviously would keep the capital down), it wouldn't make any difference at all. Because in *McCandless* the court was looking for return on capital merely in terms of a percentage of profits.

If you haven't a million dollars of earnings for a firm, mind you this is not per partner, when twenty partners get together it's not that unusual for them to produce a million dollars of earnings among them. And if the dividend tariff on that is $150,000 (at the 15% rate), then you are paying a corporate tax completely beyond what anybody, I'm sure, would be willing to consider. So I think you must seriously consider this problem, this risk of an automatic dividend or imputing of a return on capital to the partners that go into the professional corporation.

Well, that was the *McCandless* case. It's not the most recent. The field is beginning to proliferate with authority. The *Barton-Gillet* case[2] was decided in the 4th Circuit Court of Appeals. It is the only

[2] Barton-Gillet Co., 442 F.2d 1343 (1971), aff'g per cur. T.C. memo. 1970-757.

case in the area where a court of appeals, to my knowledge, has actually spoken, and they've spoken only terribly tersely, they've spoken per curiam: affirmed without opinion the memorandum decision of the Tax Court; but let's look at the *Barton-Gillet* case.

There the salary was held to be unreasonable. Now, again, in *Barton-Gillet* we're not dealing with a professional corporation. "I want to make that perfectly clear." It involved a commercial printer, largely personal services. The services of the son of the founder was being dealt with. The court held that the salary was unreasonable. Mind you, there was a finding of unreasonableness; but let's see how the court reached that "unreasonable" finding. They said, first of all, that in a personal service business some return on capital is proper, even though they conceded it would be less than would be proper in a manufacturing business. Some return on capital is proper, said the court, and they cited *McCandless.*

The court, then looked at the relationship between the salaries being paid, and both the gross profit and the net profit. The court said they were disturbed by the relationship in this case, where they found in some years that the compensation exceeded 50% of profits. Now there are obviously many instances in which it is perfectly appropriate that compensation may represent close to 100% of net profits. Indeed, hardly is this an unusual situation. Corporations could operate at a loss by reason of a need to pay reasonable compensation. Yet, in this case the court really wasn't talking about whether this compensation exceeded national norms, as in the *Pepsi Cola* case,[3] for example, where the Tax Court tried to look at what were national norms of compensation. What they said here is simply that the relationship suggested unreasonable compensation, without indicating or spelling out why.

The second factor that the court was troubled by was the fact that no dividends had been paid. Those two factors were why the court arrived at the convenient determination, convenient in terms of falling into more traditional tax concepts, of unreasonable salary. But the unreasonable salary in *Barton-Gillet* was probably no different than the reasonable salary in many other cases. The court merely hung on the unreasonable peg to justify its decision. And therefore I don't think that you can dismiss *Barton-Gillet* as being a perfectly garden variety determination that unreasonable compensation will not be allowed. The basis of unreasonableness was largely that there wasn't return on capital. So you have the *McCandless* doctrine in kind of a disguised setting.

Now the most recent case of all is *Nor-Cal,*[4] a Tax Court memorandum decision. (I emphasize "memorandum" for the obvious reason that memorandum decisions are not normally accorded as having prec-

[3] Pepsi-Cola Niagara Bottling Corp., 48 T.C. 75 (1967), rev'd 399 F.2d 390 (CA2, 1968).

[4] Nor-Cal Adjusters, T.C. Memo. 1971-200.

edential value, but nevertheless these "nonprecedential" cases do tend to get loose and spread their doctrine.) Now in *Nor-Cal*, though the court determined that the salary was reasonable, in fact very modest—what was involved was a bonus payment spread among four partners. The total bonus was $13,000 and was divided among four people. Some of them were getting two or three thousand dollars bonus, and the compensation to which the bonus had been geared was conceded by the court to be reasonable. It's not quite clear whether in *Nor-Cal* the court viewed the basic salary and the bonus together as reasonable, but they clearly conceded that the basic salary was reasonable; and the bonus added two or three thousand dollars, so I could scarcely imagine that that would have tipped it over to unreasonable.

So we had a case of a reasonable bonus; but the court said the bonus will not be deductible under these circumstances where it was not intended as compensation, but rather as a distribution of profits. Now I will agree that in the *Nor-Cal* case the court was able to point to circumstances that tainted the bonus. It was a clumsily done job. The bonus was paid periodically during the year in dribs and drabs. Obviously you will appreciate that the total bonus was itself only a drib when I tell you it was only $13,000. But they would dole out $1,000 in March, and $2,000 in June, and so on. So without any predetermined pattern of paying, formula for paying the amounts, the court said it looked like when cash was available, they turned it out to the partners. One could dismiss the *Nor-Cal* case too, as not being that significant, as merely an instance of a clumsy bonus. And as such, the case would have limited significance. However, the court, it seems to me, is dealing once again with this basic problem of a reasonable salary in a modest amount, which the court nevertheless finds unallowable. Moreover, the case does echo the *McCandless* doctrine. The court says specifically that an investor normally expects a return on capital, and the absence of dividends invites scrutiny. So while there are differences in the facts and one can distinguish the cases, you nevertheless have, in my view, again a *McCandless* type case.

This, again, was not a case involving a professional corporation. There are, in fact, two cases that really do involve professional corporations which invite our attention. Now somewhat old, in the way tax cases go (they are about ten years old, which seems like eons ago), one of them, the most important, is the *Klamath*[5] case, a 9th Circuit decision affirming the Tax Court. There what you had was an ambiguous employment agreement. I don't want to take the time to go into the factual determinations, you can read the *Klamath* case. The significant thing in *Klamath* was that there was a group of doctors that formed a medical association for the purpose of providing medical

[5] Klamath Medical Service Bureau, 29 T.C. 339 (1952), aff'd 261 F.2d 842 (CA, 1959) cert. den. 359 U.S. 966 (1959).

service on a prepaid contract basis; and also, besides that, the Klamath organization provided hospital care.

There were ambiguities in the relationship. There was a schedule of fees, and the doctors agreed—all the doctors of that particular county belong to the Klamath Medical Service Bureau. And they all held stock, but they paid a hundred dollars a share for that stock. They were stockholders only in a very nominal way. All of the compensation paid to these doctors that was challenged successfully in the *Klamath* case involved amounts paid for services, and the basic question in *Klamath* was whether the amount paid to these doctors over their billings, over the part allocable to them as billings, was excessive compensation. You see, under this ambiguous agreement they agreed to render services per schedule. That was the relationship, the so-called employment arrangement, between doctor and association. In addition, the association had subscriber contracts. Under that the subscriber was told that the doctor will perform services per schedule.

Now the court construed this as an instance in which the doctors agreed to be paid only such and such an amount as their compensation. And, therefore, it could hold that anything they received over the amount they agreed to take per schedule was in effect a volunteered payment, was almost gratuitous. In fact, one of the grounds on the basis of which the circuit court affirmed the Tax Court was that it wasn't an ordinary and necessary payment because not having been obligated contractually, the amount paid over 100% of the billings couldn't be necessary. To my mind a very specious holding; a throwaway point, but it's there. So one could again dismiss the *Klamath* case as essentially involving that rather simple proposition; but I think it would be dangerous to do so.

I think it could also be dangerous to ignore the *Klamath* case simply because it's ten years old. It is at the present time the only significant professional corporation case. There were findings that the amounts paid to these doctors, even though exceeding for the individual doctors 100% of their billings, were perfectly reasonable, and below what the doctors might have experienced in private practice. Nevertheless, said the court, the payments fell before the challenge of the Commissioner on the ground that they were not in fact reasonable to the extent that they exceeded what the court held was the amount the doctors agreed to receive, which was 100% of their billings. As I say, a very questionable determination, but nevertheless one that might distinguish the *Klamath* case.

Now the only other case that I think you must be aware of at the present time in this area is *McClung Hospital Inc.*[6] *McClung* again was a doctor case, a professional corporation of an early vintage, 1960; and 100% of the billings in the aggregate were paid to two doctor shareholder-employees. There were only two shareholder-employees.

[6] TC Memo. 1960-86.

(Well, there were three. The third was the father, who at the age of 70 was receiving compensation; and the case to an unimportant extent deals with the compensation paid to the father.) The importance of the case is its holding as to the compensation paid to the two doctor sons, who really carried on the practice. In the *McClung* case, it's important to know, the court sustained the compensation against the challenge of the Commissioner. The Commissioner agreed that 100% of billings, paid as compensation, was inappropriate because it didn't take into account the overhead expenses of operation. The Commissioner further agreed that even though 100% of the billings were paid in aggregate, in one case one doctor got more than 100% and one doctor got less than 100%; but the Tax Court wasn't persuaded by that fact either. So much for the cases.[7]

Now, I'm going to, quickly I'm afraid, race through what I think are some of the propositions that we have to be concerned about as a result of these cases, and general considerations that these cases suggest. Of course, the principal problem we must beware of is the "automatic dividend rule." Is there a *McCandless* rule in the field? The most direct statement I have found against this is provided by the Court of Claims itself—the same Court where *McCandless* was decided—in the *Bringwald* case,[8] where the Court said it rejected the Government's contention that "the low rate of return realized by the taxpayer and the fact that it never paid any dividend support an inference that the disputed (salary) payments constitute a distribution of the profits." Though *McCandless* has been cited approvingly several times in recent Tax Court decisions, and its philosophy of the right-to-a return has, as we have seen, been echoed, its "automatic dividend" rule has not actually been applied to decide any other case.[9]

I think that even if there were to develop an "automatic dividend" rule generally, remember that *McCandless* did not involve a professional corporation case, and apparently didn't even involve a personal service case and so there's a good question in my mind whether the rule would apply in case of a professional corporation, where it's generally recognized that capital is not a material income-producing factor. There are instances where this is recognized in the Code itself. Section 911, and now section 1348, both recognize as a basic proposition that a professional group, even though employing assistants and even though utilizing sophisticated equipment, nevertheless by its nature is not a business in which capital is material; and therefore all of the earnings of such an entity qualify as "earned income." Now if all of those earnings are earned income for purposes of 1348 (that is a

[7] For survey of additional post-*McCandless* cases, see Tax Management Memorandum, "Reasonable Compensation—Recent Developments," TMM 72-01 (Jan. 10, 1972).

[8] Bringwald, Inc. v. U.S., 334 F.2d 639 (1964).

[9] See TMM 72-01, supra n.7.

compensation test under 1348, it is compensation for personal services that gives the right to enjoy the maximum tax limitations of 1348), if the proposition is established there, it seems to me that one has a very strong argument that in the professional corporation area, capital is not a material income-producing factor, and that fact alone might provide you with a basis for distinguishing the *McCandless* doctrine, and *Nor-Cal* and *Barton-Gillet*, assuming those cases were to be applied in the professional corporation area.

The next point is: even if some return on capital is appropriate, must this return on capital be paid out? Isn't it perfectly acceptable for the earnings to be retained, that is, that the investor, to the extent that he is looking for a return on capital, leaves his capital in the business? Mind you in *McCandless* there was a payout test. The court said that the investor was looking for a paid-out return on capital, not merely an increment to his investment. I submit that proposition is extremely dubious. It's one thing to say a return on capital is what an investor looks for. It's another thing to say that necessarily one must constructively impute to him the receipt of the return on capital in the form of a distribution.

Now a few other propositions quickly, because time is running and I don't want to infringe on the time of the next speaker. If there is a return-on-capital rule, an "automatic dividend" rule, what is the capital base to which this return on capital must be constructed. Carr, to my mind very correctly and properly, suggested to you that the best approach—for other reasons as well, but certainly in the compensation area too—is to keep the capital lean and trim. To that extent, the return on capital will presumably commensurately be lean and trim; although bear in mind again that in *McCandless* it wasn't a return on capital invested, as such, but merely a test of a percentage of profits that the court used without regard to how much the capital was. But nevertheless it can't hurt to keep capital trim.

Now the question is, assuming you have capital, is it the original capital, is it depreciated capital, and does it include goodwill? Is goodwill a part of capital? How can goodwill be an element of capital? Well, Martin Worthy, in one of his early statements on this point as Chief Counsel of the Service, in fact stated that one must take into account goodwill, and strongly suggested that goodwill might represent an appropriate element to be compensated for over and above compensation for personal services.[10]

Next, what is the measure of a return on capital? In the *McCandless* case, remember, it was 15% of profits without any rationale, without any basis. In Martin Worthy's remarks in the Journal of Taxation, in February of '70, he spoke of a minimum of 15% of capital, by which he meant the actual capital invested. He suggested that might be an

[10] "What Lies Ahead for Professional Corporations," J. Taxation (Feb. 1970) 88, at 91.

appropriate return for an investor, when you have high interest rates for loans running as high as 10% at the time he was speaking. The speakers this afternoon will be dealing with real estate shelters. Under various situations—the rent control situation in New York, for example—an 8% return on capital is deemed appropriate, and it's not even an 8% return, it's 6-and-2 with 2% representing an amortization element. Why, then, did that government spokesman believe a 15% return on capital is a minimum return for an investor?

It seems to me that in these cases of professional corporations and professional partnerships, where partners put in excess capital by way of loans, and those cases where the partnership agreement provides that some kind of an interest factor is paid to those partners with excess capital, one might see something like 7% or 8%. Query, isn't that a more appropriate figure as a return on capital if you are going to use a return on capital at all. So there is a great deal of variation and question as to just what is the appropriate number, multiplier.

How can you limit this number? How can you limit this return on capital? Well, obviously, to the extent that you establish interest-bearing loans in lieu of actual capital investments, and you describe a rate of interest on the loan, you both have a deduction to the corporation and the amount presumably has been prescribed by a contractual agreement. I would suppose in those cases the Commissioner would have considerable difficulty overturning that rate of interest.

One suggestion I have heard is to have a partnership lease its properties, its goodwill and other properties, to the corporation. I suspect that there would be a serious question of respect for the entity, and the Commissioner would obviously not stand by idly and say, "oh yes, that's a corporation and that's a partnership, and never the twain shall meet." He would tend to throw the two together in a single entity, and look at it as a composite picture; and I don't think the siphoning off of earnings through the royalty route by any means avoids the problem. I think perhaps, in fact, it might tend to highlight a problem. But I say this on the basis of a very superficial analysis of the device. If they are doing it out west as I have heard, I don't necessarily subscribe to H. L. Mencken's aphorism about how his respect for the east grew the farther west he went.

I regret that there are too many other aspects of this problem which though worthy of consideration (including, for example, the question whether Subchapter S is the way out) are outside my time limit.