Compensation to Law Firm Shareholder-Employees Disallowed by Tax Court

In *Brinks*,[1] the Tax Court once again applied the independent investor test to recharacterize compensation paid by a professional corporation, a law firm, to its shareholder-employees as nondeductible dividend distributions, and held the corporation liable for accuracy-related penalties for mischaracterizing the dividends as deductible compensation.

Facts of Case

The taxpayer was an intellectual property law firm organized as a C corporation which used the cash basis of accounting. During the years in issue, the taxpayer employed about 150 attorneys, of whom about 65 were shareholders, and also employed a non-attorney staff of about 270.

Each shareholder-attorney of the taxpayer acquired his or her shares at a price equal to their book value and is required by agreement to sell his or her shares back to the taxpayer at a price determined under the same formula upon terminating his or her employment. Subject to minor exceptions related to the firm's "name partners," each shareholder-attorney's proportionate ownership of taxpayer's shares ("share-ownership percentage) equals his or her proportionate share of compensation paid by the taxpayer to its shareholder-attorneys. For the years in issue, the board of directors of the taxpayer set the yearly compensation to be paid to shareholder-attorneys and then determined the adjustments in the shareholder-attorneys' share-ownership percentages necessary to reflect changes in proportionate compensation. These adjustments in share ownership were effected by share redemptions and reissuances.

For at least 10 years prior to and including the years in issue, the taxpayer did not pay any dividends to its shareholders. In late November or early December of the year preceding the compensation year, the taxpayer's board meets to set the amount available for all shareholder-attorney compensation for that year, set compensation and share-ownership percentages. Because the board's estimate of the amount available for compensation-year payments to shareholder-attorneys is only an estimate, each shareholder-attorney receives during the course of the compensation year only a percentage of his or her expected compensation (draw), with the expectation of receiving an additional amount (year-end bonus) at the end of the year. The board intended the sum of the shareholder-attorneys' year-end bonuses to reduce the taxpayer's book income to zero. With limited exceptions for certain older, less active attorneys, shareholder-attorneys shared in the bonus pool in proportion to their draws (and, likewise, in proportion to their share-ownership percentages). For each of the years in issue, 2007 and 2008, the taxpayer calculated the year-end bonus pool for 2007 to be $8,986,608 and for 2008 to be $13,736,331, which equaled its book income for the year after subtracting all expenses other than the bonuses.

The taxpayer treated as employee compensation the total amounts paid to its shareholder-attorneys, including the year-end bonuses. The taxpayer used an independent payroll processing firm to prepare Forms W-2 for 2007 and 2008 to its shareholder-employees, which Forms W-2 were then forwarded to its accountant, McGladrey and Pullen (McGladrey).

[1] *Brinks Gilson & Lione, P.C. v. Comm'r,* TCM 2016-20

The taxpayer had invested capital, measured by the book value of its shareholders' equity, of approximately $8 million at the end of 2007 and approximately $9.3 million at the end of 2008. Although the taxpayer's expert witness opined at trial that clients base hiring decisions on the reputations of individual lawyers rather than those of the firms at which they practice, the expert did admit that a firm's reputation and customer list could be very valuable entity-level assets.

The taxpayer's return had previously been audited for 2006, and resulted in a "no change" letter. However, when the IRS audited the taxpayer for 2007 and 2008, the year-end bonuses that the taxpayer paid to its shareholder-attorneys were disallowed as nondeductible dividend distributions. After negotiations, the parties entered into a closing agreement providing that portions of the taxpayer's compensation deductions to its shareholder-employees for the years in issue, $1,627,000 in 2007 and $1,859,00 in 2008, should be disallowed and recharacterized as nondeductible dividends. Consequently, the only issue remaining for decision was whether the taxpayer was liable for accuracy-related penalties on underpayments of tax relating to amounts deducted as compensation that it conceded were nondeductible dividends.

Accuracy-Related Penalties

Sections 6662(a) and (b)(1) provide for accuracy-related penalty of 20% of the portion of an underpayment of tax attributable to negligence or disregard of rules and regulations. Sections 6662(a) and (b)(2) provide for the same penalty on the portion of an underpayment of tax attributable to "any substantial understatement of income tax." Section 6662(d)(2)(A) defines the term "understatement" as the excess of the tax required to be shown on the return over the amount shown on the return as filed. In the case of a corporation, an understatement is substantial if it exceeds the lesser of (1) 10% of the tax required to be shown on the return for the tax year, or (2) $10 million. An understatement is reduced, however, by the portion attributable to the treatment of an item for which the taxpayer has "substantial authority."[2] Additionally, Section 6664(c)(1) provides an exception to the imposition of the Section 6662(a) accuracy-related penalty if it is shown there was "reasonable cause" for the underpayment and the taxpayer acted in good faith.

Although the taxpayer did not dispute that the deficiency to which it has agreed for the years in issue exceeds 10% of the agreed income tax it was required to show on its returns for such years, the taxpayer argued that it has substantial authority for deducting in full the year-end bonuses paid to its shareholder-attorneys. In addition, the taxpayer argued that because it relied on the services of a reputable accounting firm to prepare its returns for the years in issue, it had reasonable cause to deduct those amounts and acted in good faith in doing so.

Substantial Authority

The Tax Court's analysis of whether the taxpayer had substantial authority for its position provides valuable insight as to the Tax Court's current position on the ability to recharacterize wages paid to shareholder-employees of professional corporations as nondeductible dividend distributions. Specifically, the IRS claimed that the amounts paid to the shareholder-employees of the corporation did not qualify as deductible compensation to the extent the payments were

[2] Section 6662(d)(2)(B)(i).

funded by earnings attributable to the services of non-shareholder employees or to the use of the corporation's intangible assets or other capital. Rather, amounts paid to shareholder-employees that are attributable to such sources must be characterized as nondeductible dividends. In support of its position, the IRS relied primarily on its opinion in *Pediatric Surgical Associates*,[3] and the recent decision by the Seventh Circuit Court of Appeals in *Mulcahy*[4] (affirming the Tax Court's decision).

The *Pediatric Surgical Associates* Case

In *Pediatric Surgical Associates*, the Tax Court recharacterized a portion of the amounts paid as wages to the shareholder-employees of a C corporation conducting a medical practice as nondeductible dividend distributions.

Under the facts of *Pediatric Surgical Associates*, the taxpayer was a personal service corporation which, through its surgeon-employees, provided pediatric surgical services to its patients. The taxpayer used the cash method of accounting and had never declared a dividend to any of its shareholders. During the years in issue, the taxpayer employed approximately twenty individuals, including six pediatric surgeons. The shares of stock of the taxpayer were owned exclusively by individuals who were employed by the taxpayer as surgeons. From 1/1/1994 through 6/30/1995, the shareholders were Drs. Ellis, Mann, Miller and Black, and from 7/1/1995 to 12/31/1995, the shareholders were all of such doctors except Dr. Ellis, who ceased to be a shareholder on 6/30/1995.

Under their employment contracts with the taxpayer, the shareholder-employees received a monthly base compensation, and equal bonuses on a monthly basis in amounts based on the cash in taxpayer's bank account, less cash necessary to meet anticipated cash flow needs for the immediate and near future. During the years in issue, the taxpayer also employed two surgeons who were not shareholders of the corporation. Under the employment agreements of the non-shareholder employees, they were paid a fixed salary and received no bonuses from the taxpayer.

The IRS sought to recharacterize that portion of the wages paid to the shareholder-employees attributable to the net profits of the non-shareholder employees (collections of non-shareholder employees less direct expenses and allocable share of overhead), as dividends. The IRS stated that Section 162(a)(1) establishes a two-prong test for the deductibility of payments purportedly paid as salaries. To be deductible as compensation for services, the payments must be: (1) reasonable; and (2) in fact payments merely for services. The IRS argued that the portion of the compensation paid to the shareholder-employees equal to the net profits of the non-shareholder employees did not constitute a payment for services rendered by such shareholder-employees, but rather constituted a nondeductible, disguised dividend.

In reaching its decision that the portion of the wages paid to the shareholder-employees attributable to the net profits of the non-shareholder employees constituted a dividend, the court rejected the argument advanced by the taxpayer that *Richlands Medical Association*[5] established

[3] *Pediatric Surgical Assocs. v. Comm'r*, TCM 2001-81.
[4] *Mulcahy, Pauritsch, Salvador & Co. v. Comm'r,* 680 F.3d 867 (CA-7 2012), *aff'g* TCM 2011-74.
[5] TCM 1990-660, *aff'd without published opinion* 953 F.2d 639 (CA-4 1992).

a rule of law that an employer may deduct as compensation paid to an employee an amount equal to the collections received by the corporation for services performed by such employee.

The *Mulcahy* Case

In *Mulcahy*,[6] the Seventh Circuit Court of Appeals affirming the Tax Court, held that over $850,000 paid in each of the three years in issue to entities owned by each of the founding shareholders of an accounting firm operated as a C corporation should be recharacterized as nondeductible dividend distributions. The *Mulcahy* case represents the first case in which a court has applied the so-called "independent investor test" in determining reasonable compensation in the professional service corporation setting.

Under the facts of the case, an accounting firm operated as a C corporation, had 40 employees located in multiple branches, and, according to the court, had both physical capital and intangible capital (in the form of client lists and brand equity).

Although the corporation had revenues between $5 million to $7 million annually, the corporation itself had little or no income because its gross revenues were offset by deductions for business expenses, primarily compensation paid directly or indirectly to its owner-employees, which included three of the firm's accountants whose names form the name of the firm and owned more than 80 percent of the firm's stock (the "Founding Shareholders"). The firm reported taxable income of only $11,279 in 2001, a loss of $53,271 in 2002 and zero taxable income in 2003. In addition to the salaries received by the Founding Shareholders that totaled $323,076 in 2001, the corporation additionally paid more than $850,000 in "consulting fees" for each of the three years in issue to three entities owned by the Founding Shareholders, which in turn distributed the money to the Founding Shareholders.

The IRS did not question the salary deductions, but disallowed the consulting fees paid to the three entities owned by the Founding Shareholders as nondeductible dividends, resulting in a deficiency in corporate income tax of more than $300,000 for each of the three years in issue.

As will be discussed in more detail below, the Seventh Circuit found that the accounting firm would flunk the independent-investor test if it were to treat the consulting fees as salary expenses, since they reduced the firm's income such that the return to a hypothetical equity investor of the corporation would be zero or below zero.

In its decision, the Seventh Circuit found that although the independent investor test may not be applicable to the "typical small professional services firm," the accounting firm in issue was not a very small firm because of its physical capital, numerous employees and intangible capital. Consequently, as stated above, the Seventh Circuit found that the Tax Court was correct to reject the firm's argument that the consulting fees were salary expenses because treating such expenses as salary reduced the firm's income, and thus the return to the hypothetical equity investor, to zero or below zero. The Seventh Circuit specifically found that there was no evidence that the "consulting fees" were compensation for the Founding Shareholders' accounting and consulting services, but rather were nondeductible dividend distributions.

[6] *Mulcahy, Pauritsch, Salvador & Co. v. Comm'r,* 680 F.3d 867 (CA-7 2012), *aff'g* TCM 2011-74.

The court specifically rejected the firm's argument that since the consulting fees were allocated among the Founding Shareholders in proportion to the number of hours that each of them worked, rather than their stock ownership, those fees could not have been dividends. The court stated that whatever the method of allocation of the firm's income (in accordance with stock ownership or otherwise), if the fees were paid out of corporate income—if every compensated hour included a capital return, the firm owed corporate income tax on the net income hiding in those fees and specifically stated that "a corporation cannot avoid tax by using a cockeyed method of distributing profits to its owners."[7]

The court went on to state that "remarkably, the firm's lawyers (***an accounting firm's lawyers***) appear not to understand the difference between compensation for services and compensation for capital … ." The court also noted its puzzlement that the firm chose to organize as a conventional business corporation in the first place, and scathingly concluded by stating "That an ***accounting firm*** should so screw up its taxes is the most remarkable feature of the case."

Independent Investor Test

Much of the Tax Court's decision addressed the application of the "independent investor test" in determining the deductibility of compensation paid by a C corporation to its shareholder-employees. As discussed above, *Mulcahy* was the first case in which the court applied the independent investor test to a professional services corporation. The Tax Court stated that well before the years in issue, an increasing number of Federal Courts of Appeal, including the Court of Appeals for the Seventh Circuit, were moving away from a multi-factor analysis in assessing the deductibility of amounts paid as compensation to shareholder-employees and focusing on the effect of the payments on the returns available to the shareholders on their capital.[8] Under the independent investor test, the courts consider whether payments made as salary to shareholder-employees meet the standards for deductibility by taking the perspective of a hypothetical "independent investor" who is not an employee. In essence, the test provides that if the corporation's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being syphoned out of the corporation as disguised salary. Consequently, ostensible compensation payments made to shareholder-employees by a corporation with significant capital that zeroes out the corporation's income and leaves no return on the shareholders' investment fails the independent investor test.

The Tax Court found that the taxpayer had substantial capital even without regard to any intangible assets based on the shareholders' equity of $8 million at the end of 2007 and $9.3 million at the end of 2008. The Tax Court found that investor capital of this magnitude cannot be disregarded in determining whether ostensible compensation paid to shareholder-employees is

[7] See also, Kennedy v Comm'r, 671 F.2d 167 (6th Cir 1982)*, rev'g and remanding* 72 TC 793 (1979), where the court found that the fact that compensation payments are not made in proportion to the shareholder-employee's stock ownership does not preclude a finding that the compensation payment actually constituted a dividend.
[8] See *Exacto Spring Corp. v. Comm'r,* 196 F.3d 833 (CA-7 1199), rev,'g *Heitz v. Comm'r*, TCM 1998-220); *Rapco, Inc. v. Comm'r, 85 F.3d 950* (CA-2 1996), *aff'g* TCM 1995 - 128; and *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241 (CA-9 1983)*, rev'g and remanding* TCM 180-282.

really a distribution of earnings. Consequently, the Tax Court concluded that the taxpayer's practice of paying out year-end bonuses to its shareholder-employees that eliminated its book income failed the independent investor test.

The taxpayer argued that Section 83 and its accompanying regulations, dealing with transfers of property in connection with the performances of services, as well as the fact that the shareholder-employees acquired their stock at a price equal to its cash book value and must sell their stock back to the corporation for a price determined under the same formula upon terminating their employment, suggests that its shareholder-attorneys lack the normal rights of equity owners, and as such, that the independent investor test should not apply in their case. The Tax Court specifically rejected both of these arguments and stated the following:

> "More generally, petitioner's argument that its shareholder-attorneys have no real equity interest in the corporation that would justify a return on invested capital provides too much. If petitioner's shareholder-attorneys are not its owners, who are? If the shareholder-attorneys do not bear the risk of loss from declines in the value of the assets, who does? The use of book value as proxy for fair market value deprives the shareholder-attorneys of the right to share in the unrealized appreciation upon selling their stock -- although they are correspondingly not required to pay for unrealized appreciation upon *buying* the stock. Acceptance of these concessions to avoid difficult valuation issues does not compel the shareholder-attorneys to forego, in addition, any current return on their investments based on the corporation's profitable use of its assets in conducting its business. Petitioner's arrangement effectively provides its shareholder-attorneys with a return on their capital through amounts designated as compensation. Were this not the case, we do not believe the shareholder-attorneys would be willing to forego any return on their investments."

The Tax Court then went on to refute the argument made by the taxpayer that the *Ashare* case,[9] in which the Tax Court did allow the taxpayer to deduct compensation that exceeded the corporation's revenue for the years in issue, established the principal that a law firm with significant capital can pay out compensation that eliminates book income. The Tax Court pointed out that the taxpayer in the *Ashare* case did not consistently pay compensation that had the intended effect of eliminating book income and that the shareholder had invested only minimal capital in the corporation ($1,000).

The Tax Court then went on to reject the taxpayer's purported authorities that establish that capital is not a material income producing factor in a professional services business because the cases cited by the taxpayer did not address the deductibility of compensation paid to shareholder-employees.[10] The Tax Court expressly stated that these authorities do not support the proposition

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[9] *Law Offices-Richard Ashare, P.C. v. Comm'r.*, TCM 1999-282.

[10] See, e.g., *Hubbard - Ragsdale Co. v. Dean*, 15 F.2d 410 (S.D. Ohio 1926), *aff'd per curiam*, 15 F.2d 1013 (CA-6 1926); Reg. 1.704-1(e)(1)(iv); and Reg. 1.1361-2(e)(2) (prior to its removal by T.D. 8104, 1986-2 C.B. 153).

that a corporation with substantial capital can pay deductible compensation to its shareholder-employees in amounts that leave no return to the shareholders on their investments in the corporation.

Finally, the Tax Court readily dismissed the taxpayer's claim that the portion of the year-end bonuses determined to be nondeductible as compensation should nonetheless have been deductible as interest based on the taxpayer's claim that its stock was really debt.

In concluding that the taxpayer did not have substantial authority for its position, the Tax Court again reiterated that the independent investor test weighs strongly against the claimed deductions.

Reasonable Cause and Good Faith

The Tax Court then addressed the taxpayer's argument that it had reasonable cause for its position and acted in good faith. Specifically, the taxpayer alleged that its reliance on McGladrey to prepare its returns for the years in issue constituted reasonable cause and demonstrated good faith. The Tax Court found that the taxpayer's argument failed for two reasons.

First, the record provides no evidence that McGladrey advised petitioner regarding deductibility of the year-end bonuses. Second, in characterizing the compensation for services amounts that have been determined to be dividends, the taxpayer failed to provide McGladrey with accurate information.[11]

The Tax Court concluded that the taxpayer consistently followed a system of computing year-end bonuses that disregarded the value of its shareholder-attorneys' interest in the capital of the firm and inappropriately treated its compensation amounts that eliminated the firm's book income. Specifically, the Tax Court stated that "Although petitioner offered no evidence as to why it adopted its practice of paying year-end bonuses, it is difficult to imagine reasons that are not tax related."

Observation

As demonstrated by the *Brinks* case and the *Mulcahy* case, it is very difficult, if not impossible, for most professional corporations to meet the independent investor test where the professional corporation distributes all or substantially all of its income in the form of compensation to its shareholder-employees (in which case the return for the independent investor would be 0%). The *Brinks* and *Mulcahy* cases represent yet another tool in the IRS's arsenal for attacking compensation paid to the shareholder-employees of a professional services corporation. In addition, the IRS has the ability to attack compensation paid to the shareholders of a professional services corporation based on the compensatory intent prong of Reg. 1.162-7(a), as demonstrated by *Richlands Medical Association,*[12] and *Pediatric Surgical Associates.*[13] The *Brinks* case should

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[11] The court also rejected the taxpayer's argument that the "no-change" letter it received at the conclusion of the audit of its 2006 return was sufficient to establish reasonable cause and good faith.
[12] *Richlands Medical Association v. Comm'r*, TCM 1990-66, *aff'd without published opinion*, 953 F.2d 639 (CA-4 1992).

send a strong message to mid-size to large personal service corporations operating as C corporations that the courts can and will recharacterize wages as nondeductible dividends where the professional corporation's normal practice is to zero out all income by payment of compensation to its shareholder-employees.

[13] TCM 2001-81.