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## Recharacterization of Unreasonable Compensation: An Equitable Mandate

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THE RECHARACTERIZATION OF UNREASONABLE  
COMPENSATION: AN EQUITABLE MANDATE

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I. INTRODUCTION

Internal Revenue Code section 162(a)(1), hereinafter referred to as section 162, limits an employer's income tax deduction for salaries or other compensation paid or

accrued to a “reasonable allowance”<sup>1</sup> for services “actually rendered.”<sup>2</sup> When an amount paid is in excess of a reasonable allowance, a question arises as to the proper characterization of the non-deductible portion. The courts have been inconsistent in their treatment of this “unreasonable” amount. Sometimes they have recharacterized the payment as something other than compensation,<sup>3</sup> while at other times they have been unwilling to recharacterize the payment, claiming that the employer is bound by the original form of his transaction.<sup>4</sup>

Case law abounds with decisions testing the amount of compensation deducted based on a two-pronged standard of 1) reasonable amount and 2) compensatory intent.<sup>5</sup> If the properly deducted amount has been determined by the Internal Revenue Service or the courts to be less than the originally deducted amount, then the proper characterization of the non-deductible portion, both as to the payer and as to the recipient, must be determined. Courts have recharacterized the payment as either a dividend,<sup>6</sup> a gift,<sup>7</sup> or as a payment for property,<sup>8</sup> invoking the doctrine of “substance over form.”<sup>9</sup> The courts generally have been hesitant, however, to permit a taxpayer to assert a substance over form argument to recharacterize the disallowed deduction as something other than compensation.<sup>10</sup> More often, they hold that the taxpayer is bound by the original form of his transaction.<sup>11</sup> The courts’ concern has been the inappropriateness of tax benefits that might result from a characterization other than that originally chosen. They argue that:

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<sup>1</sup>I.R.C. § 162(a)(1) (West 2001) (“In general.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—a reasonable allowance for salaries or other compensation for personal services actually rendered.”).

<sup>2</sup>*Id.*

<sup>3</sup>*E.g.*, *Montgomery Eng’g Co. v. United States*, 344 F.2d 996, 997 (3d Cir. 1965).

<sup>4</sup>*E.g.*, *Smith v. Manning*, 189 F.2d 345, 348 (3d Cir. 1951); *Sterno Sales Corp. v. United States*, 345 F.2d 552, 554 (Ct. Cl. 1965).

<sup>5</sup>I.R.C. § 162(a)(1) (West 2001). This two-pronged standard is based on the “reasonable allowance” and “actually rendered” language contained herein.

<sup>6</sup>*Kennedy v. Commissioner*, 72 T.C. 793, 806 (1979), *rev’d*, *Kennedy v. Commission*, 671 F.2d 167 (6th Cir. 1982).

<sup>7</sup>*Thomas v. Commissioner*, 135 F.2d 378, 379 (5th Cir. 1943).

<sup>8</sup>*Perlmutter v. Commissioner*, 44 T.C. 382, 403-405 (1965), *aff’d*, 373 F.2d 45 (10th Cir. 1967) (holding that payments for services to construct an asset with a useful life of more than one year are capitalized as part of the asset’s cost).

<sup>9</sup>*E.g.*, *Kennedy*, 72 T.C. at 806. *See generally*, Robert Thornton Smith, *Substance and Form: A Taxpayer’s Right to Assert the Priority of Substance*, 44 TAX LAW. 137, 172-173 (1990) (“Is a taxpayer allowed greater freedom to assert the priority of substance over form principle after a service deficiency determination? The answer would seem to depend upon whether the Service itself asserts substance over form.”).

<sup>10</sup>*Smith v. Manning*, 189 F.2d 345, 348 (3d Cir. 1951); *Sterno Sales Corp. v. United States*, 345 F.2d 552, 554 (Ct. Cl. 1965).

<sup>11</sup>*Smith*, 189 F.2d at 345; *Sterno Sales Corp.*, 345 F.2d at 554.

[A] taxpayer must normally accept the tax consequences of the way in which he deliberately chooses to cast his transactions (although the Internal Revenue Service may not be bound by his choice) . . . . It would be quite intolerable to pyramid the existing complexities of tax law by a rule that the tax shall be that resulting from the form of the transaction taxpayers have chosen or from any other form they might have chosen, whichever is less.<sup>12</sup>

In other cases, courts have chosen not to recharacterize the unreasonable payment.<sup>13</sup> Thus, the payment retains its character as compensation by both the payer and the recipient. Since it is in excess of reasonable compensation, it is non-deductible by the payer;<sup>14</sup> nonetheless, it is taxable to the recipient.<sup>15</sup> Furthermore, it remains subject to the full gamut of payroll taxes,<sup>16</sup> most notably FICA and Medicare taxes.<sup>17</sup>

The deduction limitation of section 162 has been applied historically in a manner that illuminates a singular purpose, that is, to unveil payments of a non-compensatory nature that have been disguised as compensation to create a tax benefit.<sup>18</sup> The Internal Revenue Service and the courts have used appropriate self-restraint in limiting the application of this section to those situations where compensatory intent is suspect due to a relationship between the payer and the payee that is not completely arms' length.<sup>19</sup> To do otherwise would be contrary to the notion of "free enterprise," i.e., "[a] private and consensual system of production and distribution, usually conducted for a profit in a competitive environment that is relatively free of governmental interference."<sup>20</sup> Rarely has a payment to a non-

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<sup>12</sup>*Sterno Sales Corp*, 345 F.2d at 554 (citing *Television Indus. Inc. v. Commissioner*, 284 F.2d 322, 325 (2d Cir.1960)).

<sup>13</sup>*Smith*, 189 F.2d at 348-349; *Willke v. Commissioner*, 12 F.2d 953 (6th Cir. 1942); *Estate of Kartsen v. Commissioner*, 13 T.C.M. (CCH) 1042 (1954); *Sterno Sales Corp.*, 345 F.2d at 554; *But see Garrison v. Commissioner*, 52 T.C. 281 (1969) (allowing taxpayer's amended return after audit adjustment which disallowed deduction for unreasonable compensation; and permitting character change to liquidation distribution because taxpayer did not sustain his compensation argument).

<sup>14</sup>I.R.C. § 162(a)(1) (West 2001).

<sup>15</sup>I.R.C. § 61 (West 2001).

<sup>16</sup>I.R.C. § 3121(a)-(b) (West 2001) (defining wages and employment for F.I.C.A. and Medicare tax purposes).

<sup>17</sup>I.R.C. § 3101(a)-(b) (West 2001) (imposing F.I.C.A. taxes; § 3101(a) imposing old-age, survivors and disability insurance; § 3101(b) imposing hospital (medicare) insurance).

<sup>18</sup>Andrew W. Stumpff, *The Reasonable Compensation Rule*, 19 VA. TAX REV. 371, 380 (1999).

<sup>19</sup>*See generally* GERALD A KAFKA, ESQ., *Reasonable Compensation*, 390-2d BNA TAX MGMT. PORTFOLIOS, A-5 (1998) ("Virtually all challenges by the IRS to the deductibility of compensation have occurred in the context of salary arrangements between related parties involving either dealings between corporations and shareholders or relatives of shareholders, or dealings between partners or proprietors and their relatives.").

<sup>20</sup>BLACK'S LAW DICTIONARY 675 (7th ed. 1999).

related party, paid in good faith as compensation, been rendered non-deductible solely due to a disagreement as to the reasonableness of amount. Such a disallowance would be tantamount to a governmentally imposed business judgment made by those who are less familiar with the intricacies of the business than its owners.<sup>21</sup> We accept a limited degree of governmental intervention in business operations to address public policy concerns. An example is legislation creating presumptive unreasonableness of certain compensation of executives of large, publicly traded corporations through the “golden parachute” provisions of Internal Revenue Code section 280G and the deduction limitation for executive pay of Internal Revenue Code section 162(m). These provisions were designed to protect the conflicting interests of shareholders. The widespread intervention of the government in employee salary decisions, however, stifles the small businessman’s ability to control the success or failure of his enterprise.

Equity demands that this disguise of compensation be undone through recharacterization. “If such payments are not true compensation, they must, of course, be treated as what they actually are,”<sup>22</sup> and the tax consequences of the restated characterization should fall accordingly. In other words, a “constructive correcting journal entry” is required to reclassify the original transaction as it would be had the reasonableness determination been made at the time of payment.

To tie the taxpayer to his original characterization only because it was his originally asserted characterization paves the way to unjust enrichment. Payroll tax liabilities remain attached to payments that are considered too large to be reasonable compensation.<sup>23</sup> The recipient’s treatment as compensation income could be inappropriate if the payment were truly in the nature of a gift or a dividend. If the payment were made by an S corporation, a payment of a dividend could be non-taxable.<sup>24</sup> Likewise, a dividend payment from a C corporation might properly be characterized as a non-taxable return of capital or a capital gain.<sup>25</sup> Furthermore, the payment could be a constructive dividend to the owners followed by a gift to the recipient, thus triggering transfer tax consequences.<sup>26</sup>

When the government is unwilling to recharacterize the transaction based on its subsequent determination of unreasonableness, the taxpayer is irrevocably bound by his original characterization that was based on his judgment of reasonableness. Because the determination of reasonable amount is a valuation issue based on the particular facts and circumstances at hand,<sup>27</sup> it is a highly subjective determination,<sup>28</sup>

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<sup>21</sup>*Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 835 (7th Cir. 1999).

<sup>22</sup>*Sterno Sales Corp. v. United States*, 345 F.2d 552, 556 (Ct. Cl. 1965); *Garrison v. Commissioner*, 52 T.C. 281 (1969).

<sup>23</sup>I.R.C. § 3121(a)-(b) (West 2001).

<sup>24</sup>I.R.C. § 1368(b)(1); I.R.C. § 1368(c)(1) (West 2001) (explaining tax free distribution to extent of accumulated adjustment account).

<sup>25</sup>I.R.C. § 301(c) (West 2001).

<sup>26</sup>I.R.C. § 2501 (West 2001) (imposing gift tax).

<sup>27</sup>*Mayson Mfg. v. Commissioner*, 178 F.2d 115, 119 (“The situation must be considered as a whole with no single factor decisive.”).

<sup>28</sup>*Kennedy v. Commissioner*, 671 F.2d 167, 176 (6th Cir. 1982).

one in which the good faith judgments of the government and of the taxpayer are likely to differ.<sup>29</sup> The taxpayer could not reasonably be expected to predict the government's determination at the time of the original transaction.<sup>30</sup> Therefore, his assertion of a substance over form argument characterizing his payment differently from his original treatment is justified by his new knowledge of the government's binding determination of a reasonable amount.

This note identifies the inequities inherent in the failure to recharacterize unreasonable compensation payments and proposes that the taxpayer be allowed to present evidence of an alternative characterization after the government determines a reasonable allowance.

Part I of this note demonstrates the historical applications of section 162 supporting a purpose of challenging payments disguised as compensation with an accompanying tax advantage. It will explore the legislative history and statutory implications, as well as applications in case law. Part II explains the highly subjective character of the determination of reasonableness and explores the numerous dimensions of that judgment. Part III explains the impact of that subjective determination in the formulation of intents, i.e., the intent to compensate and the intent to make a gift. Part IV deals with the issues surrounding recharacterization as constructive dividends. Part V compares the section 162 limitation on deductible compensation to other statutory provisions limiting the deduction for compensation<sup>31</sup> and distinguishes the statutory purpose of such limitations in the publicly traded setting from the section 162 limitation in the closely-held setting. Part VI integrates the findings to conclude that there is an equitable demand for recharacterization and an entitlement of the taxpayer to present evidence of an alternative characterization.

## II. HISTORICAL VIEW OF SECTION 162 AND ITS APPLICATION IN CASE LAW

The purpose of section 162 is to allow employers to deduct salary payments that are reasonable. Conversely, deductions for unreasonable salary payments must be disallowed. Thus, the intent of imposing such a limitation on deductibility is to challenge payments that have been disguised as compensation to achieve a tax advantage. This intent has been defined both by the language of the Internal Revenue Code and regulations, and by the circumstances under which the Internal Revenue Service and the courts have made reasonable compensation challenges.

### A. Statutory Provisions

The Revenue Acts of 1913 and 1916 only generally mentioned the allowance of deductions that were "ordinary and necessary expenses."<sup>32</sup> The regulations under the

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<sup>29</sup>Exacto Spring Corp. v. Commissioner, 196 F.3d 833, 835 (7th Cir. 1999).

<sup>30</sup>Id.

<sup>31</sup>I.R.C. § 280G (West 2001) (golden parachute payments); I.R.C. § 162(m) (West 2001) (limiting to \$1,000,000 deduction for compensation payments by certain large corporations).

<sup>32</sup>KAFKA, *supra* note 19, at A-1 (citing Revenue Act of 1913 § G(b)[2] (First); Revenue Act of 1916, § 12(a) (First)).

Revenue Act of 1916, however, supported a restrictive purpose.<sup>33</sup> They warned of the need to carefully analyze payments to officers or employees who were stockholders that were out of proportion to business volume or excessive when compared to similarly situated employees in other companies.<sup>34</sup> The regulations required that “the amount so paid in excess of reasonable compensation for the services will not be deductible from gross income, but will be treated as a distribution of profits.”<sup>35</sup> Thus, regulations mandated recharacterization of unreasonable compensation that is truly in the nature of a dividend.

The Revenue Act of 1918 was the first codification containing language permitting a deduction for “a reasonable allowance for salaries or other compensation.”<sup>36</sup> The legislative history does not indicate why the Act expanded its language from the former “ordinary and necessary.” One theory is that the intent was to expand deductible compensation to negate the detrimental effect of the excess profits tax of 1917.<sup>37</sup> It gave the taxpayer the ability to deduct a reasonable amount of compensation, even if such compensation was not actually paid.<sup>38</sup>

The expanded directives of current Treasury Regulations focus even more clearly on the heightened scrutiny mandated for related party transactions. In its example of practical application, Treasury Regulation section 1.162-7(b)(1) points to the possibility that a payment designated as compensation is likely not to be the purchase price for services where “a corporation having few shareholders, practically all of whom draw salaries,” makes payments “that bear a close relationship to the stockholdings of the officers or employees.”<sup>39</sup> In such cases, it would seem likely that “the excessive payments are a distribution of earnings upon the stock.”<sup>40</sup>

In addition, section 1.162-7(b)(2) invites scrutiny of contingent payments. Contingent payments are tied to the employee’s productivity. They provide an incentive to the employee, in that the harder he works, the more compensation he receives. Although these payments must be scrutinized as potential dividends, a deduction is permitted for contingent payments that are greater than ordinarily acceptable amounts when they stem from arms’ length bargains.

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<sup>33</sup>*Id.* (citing Griswald, *New Light on a Reasonable Allowance for Salaries*, 59 HARV. L. REV. 286 (1945)).

<sup>34</sup>*Id.* (citing Regs. 33 (revised, 1918), Art. 138).

<sup>35</sup>*Id.* (citing Regs. 33 (revised, 1918), Art. 138).

<sup>36</sup>*Id.* (citing Revenue Act of 1918 §§ 214(a)(I) and 234(a)(I)).

<sup>37</sup>KAFKA, *supra* note 19, at A-1 (citing Revenue Act of 1918 §§ 214(a)(I) and 234(a)(I)).

<sup>38</sup>*Id.*

<sup>39</sup>Treas. Reg. § 1.162-7(b)(1) (1960). Language is added in the current regulation to the original 1916 version noting that a correlation between excess salary payments and stockholdings might indicate a distribution of earnings rather than a salary payment. It also cautions that payment of salary might really be a payment for property, where a partnership sells out to a corporation and the former partners continue in the service of the corporation.

<sup>40</sup>*Id.*

“[I]f contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of an individual, it should be allowed as a deduction . . . .”<sup>41</sup>

In this situation, the true character of the payment is likely compensatory, and as such, the payment is deductible despite being somewhat excessive.

Thus, Treasury Regulation section 1.162-7 not only invites scrutiny of related party transactions with an eye toward inappropriate characterization, but also defends transactions such as contingent salary made in good faith with the intent to compensate. These factors combine to define a purpose to view transactions in their true character. Treasury Regulation section 1.162-8 accomplishes this purpose by mandating recharacterization of ostensible salary payments truly in the nature of a dividend or the purchase price for property.<sup>42</sup>

### B. Case Law

Virtually all challenges to compensation deductions occur within the context of related party payments.<sup>43</sup> These relationships include those between the owner of a business in his individual capacity and the business entity itself, and between the owner of a business and his family members.<sup>44</sup> The level of scrutiny accorded to these transactions tends to be proportional to the closeness of the relationships between the parties.<sup>45</sup>

The amount of stock owned by an employee is highly relevant in assessing whether bargaining is done at arms’ length. An individual who owns only a small amount of stock is likely to bargain with his employer at arm’s length.<sup>46</sup> Thus, the heightened scrutiny accorded to officer-stockholders diminishes when the employee lacks a controlling interest or owns no stock at all.<sup>47</sup>

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<sup>41</sup>Treas. Reg. § 1.162-7(b)(2) (1960).

<sup>42</sup>Treas. Reg. § 1.162-8 (1960). In instances other than in section 162, the Internal Revenue Code itself contemplates dividend payments disguised as salary. For example, foreign earned income is defined within the Code as excluding “that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings and profits rather than a reasonable allowance as compensation for services actually rendered.” I.R.C. § 911(d)(2)(A) (West 2001) (defining earned income for former I.R.C. § 1348; i.e., maximum tax on earned income).

<sup>43</sup>KAFKA, *supra* note 19, at A-5.

<sup>44</sup>*Id.*

<sup>45</sup>*E.g.*, Northlich Stolley, Inc. v. United States, 368 F.2d 272, 278 (Ct. Cl. 1966); Kropf v. United States, 543 F. Supp. 581, 581 (D. Colo. 1982).

<sup>46</sup>*See generally*, KAFKA, *supra* note 19, at A-5.

<sup>47</sup>*E.g.*, Exacto Spring Corp. v. Commissioner, 196 F.3d 833, 833 (7th Cir. 1999). A substantial factor in support of the reasonableness of compensation paid to the 55% owner was the approval of other owners whose economic positions were diminished by payment of his bonus. *Id.* “The fact that Heitz’s salary was approved by the other owners of the corporation . . . goes far to rebut any inference of bad faith here . . . .” *Id.* at 839.

Payments to owners' family members have been successfully challenged as unreasonable where the owner held a controlling interest, the family relationship was as close as spouse, former spouse, or children, and there was insufficient evidence to support the extent of services provided.<sup>48</sup> The determination to be made is whether the employer is exercising free and independent judgment in his salary determinations.<sup>49</sup> Factors to consider in addition to the closeness of the family relationship are whether the family member is adult and whether he is free to negotiate his own terms.<sup>50</sup>

Although the case of *Patton v. Commissioner* supports the notion that an adjustment for unreasonable compensation can be made for payments to an unrelated taxpayer, its strength as a precedent is weak.<sup>51</sup> In *Patton*, the party to whom unreasonable payments were made was neither an owner nor a relative of an owner, but rather an elderly, favored employee. Although he was not a related party in the sense of actual family, a strong personal relationship that evolved over many years of employment made the transaction less than arms' length.<sup>52</sup>

The intent of the restriction to reasonableness of section 162, to unveil non-compensatory payments disguised as compensation, is supported both by 1) the consistency with which section 162 has been applied to payments to related parties in closely-held businesses, and 2) the notable absence of cases involving payments made by large, publicly-traded corporations.<sup>53</sup> Although large corporations can make excessive salary payments, they are not attacked through section 162(a) because the character of the payments as compensation is not subject to dispute. The excessive payments lack the potential to be reclassified as dividends due to the strict uniformity of dividend payments made by a publicly-held corporation. The payments are restricted, however, through the provisions of sections 280G and 162(m). Challenges through section 162(a) have been reserved for closely held businesses, in which the owner can determine both the amounts and the characterizations of payments to employees. This attests to the function of section 162(a) as a vehicle to scrutinize the proper characterization of a transaction.

The incidence of section 162 challenges to subchapter S corporation<sup>54</sup> payments are relatively infrequent and limited to special situations in which there is a potential tax increase accompanying an adjustment.<sup>55</sup> Generally, by its failure to pursue S

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<sup>48</sup>*Summitt Publishing Co. v. Commissioner*, 59 T.C.M. (CCH) 833 (1990); *Eller v. Commissioner*, 77 T.C. 934, 962-964 (1981); *Graham v. Commissioner*, 35 T.C.M. (CCH) 1315, 1322 (1976).

<sup>49</sup>*Harolds Club v. Commissioner*, 340 F.2d 861, 865 (9th Cir. 1965).

<sup>50</sup>*Id.* (determining that the fact that sons of the controlling owner were adult and free to negotiate their own terms minimizes the significance of the relationship in evaluating whether the employer was exercising free and independent judgment).

<sup>51</sup>*See generally*, KAFKA, *supra* note 19, at A-5.

<sup>52</sup>*Patton v. Commissioner*, 6 T.C.M. (CCH) 482 (1947), *aff'd* 168 F.2d 28 (6th Cir. 1948).

<sup>53</sup>*See generally*, KAFKA, *supra* note 19, at A-5.

<sup>54</sup>I.R.C. § 1361(a)-(b) (West 2001). Section 1361(a) defines an S corporation; section 1361(b) lists its qualifications. One of the qualifications, that an S corporation must have 75 or fewer shareholders, differentiates it from a large, publicly traded corporation. *Id.*

<sup>55</sup>KAFKA, *supra* note 19, at A36-37.

corporation reasonable compensation issues, the Internal Revenue Service acknowledges a distinguishing aspect of S corporations. That is, due to the lack of inherent double taxation applicable to C corporation dividends, an S corporation owner has no tax avoidance purpose to achieve by overcompensating himself or other owners.

Because dividend payments by an S corporation, unlike a C corporation,<sup>56</sup> are often tax-free to the shareholder,<sup>57</sup> recharacterization of an unreasonable salary payment as a distribution to an owner of an S corporation does not generate tax revenue for the government. Rather, the unreasonable compensation produces two offsetting adjustments. First, the unreasonable salary expense is removed as a deduction,<sup>58</sup> increasing the shareholder's flow-through income by that amount. Second, compensation income is reduced by the unreasonable portion. The unreasonable compensation was transformed through recharacterization to generally non-taxable dividend income,<sup>59</sup> non-taxable because the corporation was an S corporation. An additional adjustment would be a *reduction* in payroll tax liabilities, due to the reduction in compensation income. This payroll tax reduction generates a net loss of revenue to the government; therefore, needless to say, this is a path rarely taken. This result differs from the recharacterization of unreasonable C corporation compensation expense because C corporation dividends are generally taxable to the recipient.

Conversely, if the unreasonable compensation of an S corporation shareholder were not recharacterized as a distribution, but rather retained its original characterization as non-deductible compensation, the flow-through income to the shareholder would be increased by the non-deductible portion of the compensation expense, but compensation income would remain the same. The unreasonable portion would effectively become doubly taxed. This is the same net effect as a recharacterization of C corporation unreasonable compensation as a dividend.<sup>60</sup> In this case, recharacterized dividend income is taxable to the recipient to the extent that it is paid out of the corporation's earnings and profits,<sup>61</sup> while the dividend payment by the corporation is non-deductible. This again results in double taxation, but this time without the reduction in payroll tax liabilities that accompanies recharacterization.

Although the determination of S corporation unreasonable compensation without recharacterization as a distribution would result in increased revenue for the

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<sup>56</sup>I.R.C. § 1361(a)(2) (explaining that a corporation without an effective S election is a C corporation, taxed under the provisions of I.R.C. § 301).

<sup>57</sup>I.R.C. § 1368(b)(1); I.R.C. § 1368(c)(1) (explaining tax free distribution to extent of AAA).

<sup>58</sup>I.R.C. § 162(a)(1) (West 2001).

<sup>59</sup>I.R.C. § 1368(b)(1); I.R.C. § 1368(c)(1) (explaining tax free distribution to extent of AAA).

<sup>60</sup>*E.g.*, Kennedy v. Commissioner, 72 T.C. 793, 806 (1979), *rev'd*, Kennedy v. Commissioner, 671 F.2d 167 (6th Cir. 1982).

<sup>61</sup>I.R.C. § 312 (West 2001) (explaining calculation and adjustments to earnings and profits).

government, these challenges have generally not been made.<sup>62</sup> This attests not only to a presumption of recharacterization, but also to an intent to unveil payments disguised as compensation to gain a tax benefit. In the original transaction, the S corporation shareholder has no incentive (other than as to allocation issues among the shareholders) to make excessive compensation payments, because whatever amount paid is both deductible expense and includible income. In addition, larger salary payments cost more in payroll taxes. Therefore, because the incentive to overcompensate is non-existent, S corporation compensation is rarely scrutinized.

S corporation challenges are limited to two types. The first occurred between 1970 and 1981, when Internal Revenue Code section 1348 provided a maximum tax on earned income, limiting the top marginal rate on earned income to 50 percent.<sup>63</sup> Reasonableness of compensation was challenged to determine whether the top marginal rate was properly limited to 50 percent, or whether the higher marginal rates, up to 70 percent for unearned income, were applicable.<sup>64</sup> This 20 percent marginal gap created a significant tax consequence in the determination of reasonable compensation.<sup>65</sup> Recharacterization of compensation income as dividend income was required to carry out the purpose of the inquiry, i.e., to subject only a reasonable amount of compensation income to the preferential rates of section 1348. The second S corporation challenge has been to unreasonably low compensation. Lower than reasonable compensation avoids the payroll tax liabilities that would attach to reasonable compensation. To generate appropriate payroll tax revenue, the Internal Revenue Service has issued Revenue Rulings mandating that S corporation dividends paid in lieu of reasonable compensation be treated as compensation.<sup>66</sup> These provide yet another example of a mandate to recharacterize a transaction to its true nature. Furthermore, they are exceptional circumstances in which an S corporation owner could manipulate salary payments to achieve a tax benefit.

The purpose of section 162 has been defined by language in the Internal Revenue Code, Treasury Regulations, and Revenue Rulings, warning 1) of ostensible payments of salary that are truly not compensatory,<sup>67</sup> 2) of the need to determine whether payments are in the nature of a dividend<sup>68</sup> or compensation,<sup>69</sup> and 3) of the special scrutiny needed for related party transactions.<sup>70</sup> The purpose is further defined by case law that only challenged payments to related parties in the closely-held business environment where a disguised characterization can cause tax

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<sup>62</sup>KAFKA, *supra* note 19, at A36-37.

<sup>63</sup>I.R.C. § 1348 (West 2001) (repealed by P.L. 97-34 § 101(c)(1) for tax years beginning after December 31, 1981).

<sup>64</sup>I.R.C. § 1 (West 1979); Schiff v. Commissioner, 41 T.C.M. (CCH) 659 (1980).

<sup>65</sup>Trucks, Inc. v. United States, 588 F. Supp. 638, 641 (D. Neb. 1984).

<sup>66</sup>Radtke v. United States, 895 F.2d 1196 (7th Cir. 1990); Rev. Rul. 74-44, 1974-1 C.B. 287 (1974); Rev. Rul. 73-361, 1973-2 C.B. 331 (1973).

<sup>67</sup>I.R.C. § 911 (West 2001); Treas. Reg. § 1.162-7 (1960).

<sup>68</sup>I.R.C. § 911; Treas. Reg. § 1.162-7.

<sup>69</sup>Rev. Rul. 74-44, 1974-1 C.B. 287 (1974); Rev. Rul. 73-361, 1973-2 C.B. 331 (1973).

<sup>70</sup>Treas. Reg. § 1.162-7.

avoidance.<sup>71</sup> The general absence of S corporation cases implies an acknowledgment by the government of the likelihood that the excess compensation payment could truly be tax-free dividends. Thus, in the absence of a tax avoidance intent in disguising payments to create a tax benefit, and without a potential tax increase, the Internal Revenue has generally chosen not to attack S corporation compensation.<sup>72</sup>

Combined statutory history and case law support the singular purpose of rendering payments disguised as compensation for the purpose of obtaining a tax benefit non-deductible. This is a much narrower purpose than that found in the strict construction of Treasury Regulation section 1.162-7, which, by requiring both a reasonable amount and an intent to compensate, permits disallowance of any compensation payments determined to be *either* unreasonable in amount or not intended to compensate.<sup>73</sup> Thus, although strict construction permits the disallowance of innocently excessive compensation payments resulting from discrepancies in business judgments, the historic attack has been confined to intentionally disguised payments.

### III. THE HIGHLY SUBJECTIVE DETERMINATION OF REASONABLE AMOUNT

The concept of reasonableness “defies simple interpretation by tax experts in the same manner that the legendary reasonable man escapes precise definition by negligence lawyers and the concept of reasonable doubt remains an elusive factor in the criminal law.”<sup>74</sup> The determination of how much salary is reasonable in a particular set of facts and circumstances is a valuation issue and is highly subjective.<sup>75</sup> Despite the use of certain objective tools such as empirical data and company financial information to ascertain value, personal judgment is needed to weigh the importance of the valuation criteria and to analyze the strength of comparisons to other companies.<sup>76</sup> The Sixth Circuit noted in *Kennedy v. Commissioner* that “[t]he determination of reasonable compensation under section 162(a)(1) of the Internal Revenue Code is more nearly an art than a science.”<sup>77</sup> This comment was appropriate to a case where large discrepancies in reasonable amount

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<sup>71</sup>KAFKA, *supra* note 19, at A-5, A37-38.

<sup>72</sup>*Id.* at A37-38.

<sup>73</sup>Treas. Reg. § 1.162-7. According to the regulation:

There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

*Id.*

<sup>74</sup>KAFKA, *supra* note 19, at A-2.

<sup>75</sup>*Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 835 (7th Cir. 1999).

<sup>76</sup>*Id.*

<sup>77</sup>*Kennedy v. Commissioner*, 671 F.2d 167 (6th Cir. 1982) (citing Bertozzi, *Compensation Policy for the Closely-held Corporation: The Constraint of Reasonableness*, 16 Am. Bus. L.J. 157, 186 (1978)).

determinations existed between the Internal Revenue allowance, the Tax Court allowance, and the court of appeals allowance.<sup>78</sup>

#### A. Multi-Factor Tests

The Tax Court<sup>79</sup> and various appellate circuits developed multi-factor tests to standardize the criteria for reasonable compensation determinations.<sup>80</sup> *Mayson Mfg. v. Commissioner* lists nine factors used in the Sixth Circuit: 1) Employee qualifications, 2) Nature, extent and scope of employee's work, 3) Size and complexities of business, 4) Comparison of salaries paid to gross and net income, 5) Prevailing general economic conditions, 6) Comparison of salaries paid with distributions to stockholders, 7) Prevailing rates of compensation for comparable positions in comparable companies, 8) Salary policy of employer as to all employees, and 9) Amount of compensation paid to the particular employee in previous years.<sup>81</sup> Variations on the *Mayson Mfg. v. Commissioner* theme appear in the holdings of various courts<sup>82</sup> that used factor tests incorporating up to 21 factors.<sup>83</sup>

The flaws in the use of multi-factor tests have been expounded by the courts advocating the "independent investor test" approach to determining reasonableness.<sup>84</sup> In *Exacto Spring Corp. v. Commissioner*, the Seventh Circuit enumerates five drawbacks of multi-factor tests. First, the tests are non-directive as to how to weigh conflicting, often vague factors.<sup>85</sup> Second, the factors do not clearly relate to the purpose of the restrictive reasonableness requirement of section 162, i.e., "to prevent dividends (or in some cases gifts), that are not deductible from corporate income, from being disguised as salary."<sup>86</sup> Third, the courts lack the expertise to act as a superpersonnel department for closely held corporations:

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<sup>78</sup>*Id.* at 177. In 1973, the IRS allowance was \$108,000.00, the Tax Court allowance was \$190,000.00, and the appeals court allowance was \$332,365.68 (full amount claimed). In 1974, the IRS allowance was \$120,000.00, the Tax Court allowance was \$220,000.00, and the appeals court allowance was \$301,345.00 (full amount claimed). *Id.*

<sup>79</sup>E.g., *Normandie Metal Fabricators, Inc. v. Commissioner*, 79 T.C.M. (CCH) 1738 (2000) (five factors).

<sup>80</sup>E.g., *O.S.C. & Assoc., Inc. v. Commissioner*, 187 F.3d 1116, 1121 (9th Cir. 1999) (four factors); *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 834 (7th Cir. 1999) (seven factors); *Alpha Medical Inc. v. Commissioner*, 72 F.3d 942, 946 (6th Cir. 1999) (nine factors); *Dexsil Corp. v. Commissioner*, 147 F.3d 96, 100 (2d Cir. 1998) (five factors); *Donald Palmer Co., Inc. v. Commissioner*, 69 T.C.M. (CCH) 1869 (1995), *aff'd* 84 F.3d 431 (5th Cir. 1996) (nine factors); *Elliott's, Inc. v. Commissioner*, 716 F.2d 1241, 1245-1248 (9th Cir. 1983) (five factors).

<sup>81</sup>*Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949).

<sup>82</sup>E.g., *Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1323 (5th Cir. 1987); *Edwin's, Inc. v. United States*, 501 F.2d 675, 677 (7th Cir. 1974).

<sup>83</sup>*Foos v. Commissioner*, 41 T.C.M. (CCH) 863, 878-879 (1981) (using 21 factors).

<sup>84</sup>*Exacto Spring Corp.*, 196 F.3d at 835.

<sup>85</sup>*Id.*

<sup>86</sup>*Id.*

The test . . . invites the court to decide what the taxpayer's employees should be paid on the basis of the judges' own ideas of what jobs are comparable, what relation an employee's salary should bear to the corporation's net earnings, what types of business should pay abnormally high (or low) salaries, and so forth. The judges of the Tax Court are not equipped by training or experience to determine the salaries of corporate officers; no judges are.<sup>87</sup>

Fourth, the non-directive character of the test generates arbitrary results "based on uncanalized discretion or unprincipled rules of thumb."<sup>88</sup> Fifth, the unpredictability of the determination of reasonableness forces running the risk of determining salaries that may be "indispensable to the success of their business."<sup>89</sup>

#### B. Independent Investor Test

Due to these inherent drawbacks, courts of appeal have moved toward the use of an "independent investor test."<sup>90</sup> The independent investor test is satisfied if a disinterested investor would approve the salary payment, evaluating the remaining return on investment and the potential for dividends after payment of the salary.<sup>91</sup> Courts have used the independent investor test in conjunction with multi-factor tests,<sup>92</sup> sometimes referring to the independent investor test as "a lens through which the entire analysis should be viewed."<sup>93</sup> *Exacto Spring Corp. v. Commissioner* dismisses that view as a formality, stating that "[t]he new test dissolves the old and returns the inquiry to basics."<sup>94</sup> The Seventh Circuit has held that to the extent that a company's higher than reasonably expected return on investment is attributable to the efforts of a single employee, his salary is presumptively reasonable.<sup>95</sup> It has embraced an "indirect market test,"<sup>96</sup> which justifies the salary of an employee paid to manage the company's assets by his success in increasing their value.<sup>97</sup>

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<sup>87</sup>*Id.*

<sup>88</sup>*Id.*

<sup>89</sup>*Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 835 (7th Cir. 1999).

<sup>90</sup>*Id.* at 838 (citing *Dexsil Corp. v. Commissioner*, 147 F.3d 96 (2d Cir. 1998); *Rapco Inc. v. Commissioner*, 85 F.3d 950, 954-955 (2d Cir. 1996); *Elliott's Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983)).

<sup>91</sup>*Rapco, Inc.*, 85 F.3d at 954-955.

<sup>92</sup>*E.g., Id.*

<sup>93</sup>*E.g., Dexsil Corp.*, 147 F.3d at 101. ("[I]n this circuit the independent investor test is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed."); *Normandie Metal Fabricators, Inc. v. Commissioner*, 79 T.C.M. 1738 (2000) (5 factors).

<sup>94</sup>*Exacto Spring Corp.*, 196 F.3d at 838.

<sup>95</sup>*Id.* at 839.

<sup>96</sup>*Id.* at 838.

<sup>97</sup>*Id.* As the court noted in *Exacto Spring Corp. v. Commissioner*:

If the rate of return is extremely high, it will be difficult to prove that the manager is being overpaid, for it will be implausible that if he quit if his salary was cut, and he

Although the *Exacto Spring Corp. v. Commissioner* holding with respect to an employee who is singularly responsible for the success of a company appears to diminish the subjectivity of the reasonableness determination by eliminating factor analysis, the need for other subjective judgments emerges. For example, a reasonable rate of return on investment must be determined.<sup>98</sup> The *Exacto Spring Corp. v. Commissioner* court dealt with the matter in a simplistic manner. It relied on an Internal Revenue Service expert who testified that 13 percent was reasonable.<sup>99</sup> The issue apparently was not disputed because the actual return on investment, 20 percent, was so far in excess of the 13 percent amount.

### C. Other Subjective Determinations

Another subjective determination that is required in both the multi-factor analysis and the independent investor test is the extent of the employee's contribution to the profitability of the company. Under the multi-factor analysis, the impact of the employee's efforts on profitability determines the "intent to compensate" prong of section 162. Under the independent investor test, the employee's contribution to company profitability impacts the independent investor's view of the effect of the employee's services on the actual return on investment. When the responsibility for a business's success can be attributed to just one key person, such as Heitz, the

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was replaced by a lower-paid manager, the owner would be better off; it would be killing the goose that lays the golden egg.

*Id.*

<sup>98</sup>*Dexsil Corp. v. Commissioner*, 147 F.3d 96, 101 (2d Cir. 1998) ("If the bulk of the corporation's earnings and profits are being paid out in the form of compensation such that the corporate profits do not represent a reasonable return on the shareholder's investment, then an independent investor would probably disapprove of the compensation arrangement."). *Id.*

The determination of a reasonable expected rate of return is analogous to the determination of a company's fair market value. A basic valuation principle lies in the fact that "the value of an ownership interest in a company is equal to the present worth of the future benefits of ownership." Some valuation methods are directly structured around this principle, in that they are based upon discounting an earnings stream to a present value using a discount percentage and capitalization rate that takes into consideration the risks of the investment in determining an expected rate of return. One method of determining a discount or capitalization rate is through a "build-up" method. A build-up method is based on the notion that a discount rate is based on a combination of identifiable risk factors which determine the total return that a prudent investor would demand. In Revenue Ruling 59-60, which provides standards for valuing stock of closely held businesses, the Internal Revenue Service acknowledged how imprecise the determination of a capitalization rate is and the wide variations that can exist even between companies within the same industry. Many risk factors affect an expected rate of return; these include the size of the business, its diversification of operations, financial risk; such as leverage and coverage ratios and prevailing economic conditions, ease in marketability, restrictions on transfer, and various industry risk factors, such as diversification of operations, depth of management, and competition created by technological advances. Where a company's actual return on investment is closer to the claimed reasonable expected rate of return, judgments regarding the company's inherent risks again make the judgment of reasonableness subjective and unpredictable. JAY E. FISHMAN, ET AL., *GUIDE TO BUSINESS VALUATIONS* §§ 500.1-502.16 (11th ed. 2001); Rev. Rul. 59-60 § 6, 1959-1 C.B. 237.

<sup>99</sup>*Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 838 (7th Cir. 1999).

“chief executive officer, chief manufacturing executive, chief research and development officer, and chief sales and marketing executive”<sup>100</sup> in *Exacto Spring Corp. v. Commissioner*, application of the independent investor test is simplified. It omits the allocation of contributed efforts to return on investment. The responsibility for success may sometimes be attributed to several employees, however, each of whom played an integral role in the company’s overall success. In holding that payments received under a contingent payment plan based on a pre-determined percentage of earnings were reasonable, the court in *William S. Gray and Co. v. United States* evaluated the efforts and abilities of the employees and their connection with the success of the company.<sup>101</sup> The *William S. Gray* court accepted as reasonable an allocation of contingent payments among six key employees.<sup>102</sup>

An additional dimension of the determination with regard to the employee’s contribution to profitability is the extent to which external factors also had a significant impact. Flourishing general economic conditions, for example, could be a boon to business that is not attributable to employee efforts.<sup>103</sup> The facts and circumstances of each case must be examined to determine the extent to which an employee’s efforts are responsible for increased profitability, and are therefore deserving of compensation.<sup>104</sup> The Sixth Circuit in *Mayson Mfg. v. Commissioner* refused to attribute the taxpayer’s increased sales to the fortuitous war time economy that prevailed in 1943. “[T]his alone does not establish unreasonableness where war business has resulted in increased work and responsibility.”<sup>105</sup> In *The Roth Office Equipment Co. v. Gallagher*, the Sixth Circuit explained that the war economy generated competition for the increased business, which was only procured through the employees’ efforts.<sup>106</sup> Even the *Exacto Spring v. Commissioner* court, while

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<sup>100</sup>*Compare Exacto Spring Corp.*, 196 F.3d at 836 (noting that Heitz was not only Exacto’s CEO, but also its chief salesman, marketing man, head of research and development efforts and principal inventor, and that the company’s entire success was due to Heitz’s research and development and marketing of the company’s innovations), *with Donald Palmer Co. Inc. v. Commissioner*, 69 T.C.M. (CCH) 1869 (1995) (holding that limits to compensation exist for most valuable employees where return on investment is negative).

<sup>101</sup>*William S. Gray & Co., Inc. v. United States*, 35 F.2d 968, 975 (Ct. Cl. 1925).

The men were worth to the business the compensation paid them. They could not be retained without it and the business would have suffered had they severed their connection with it. Their retention was necessary to its success, and the success was due to their efforts, and the arrangement as to percentages of profits had been made in good faith. There is nothing in the record to even suggest that this was an effort to avoid taxation.

*Id.*

<sup>102</sup>*Id.* at 970.

<sup>103</sup>*Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115,120 (6th Cir. 1949).

<sup>104</sup>*Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 839 (7th Cir. 1999).

<sup>105</sup>*Mayson Mfg. Co.*, 178 F.2d at 120 (citing *Roth Office Equip. v. Gallagher*, 172 F.2d 452, 456 (6th Cir. 1949)).

<sup>106</sup>*Roth Office Equip.*, 172 F.2d at 456.

The experience of the three officers, the contacts and good will established by years of work, hard work and long hours, plus the operation of the bonus plan enabled them to

establishing presumptive reasonableness for compensation paid to an employee who single-handedly generated a higher than expected return on investment, warned that the presumption is rebuttable due to the impact of external circumstances, such as new knowledge that the company's factory is sitting on an oil field.<sup>107</sup>

The reasonableness determination of a salary payment can also be affected by the taxpayer's contention that a payment adequately compensates the employee for past services. The Supreme Court held and the Internal Revenue Service acquiesced in the view that "a deduction for reasonable compensation is not limited to amounts paid as compensation for services rendered in current years. Payments made by an employer to an employee may be deductible as reasonable compensation for current and past services rendered."<sup>108</sup> In this situation, the determination of reasonable compensation expands to all prior years for which the payment is claimed to be made, creating additional dimensions of subjectivity.

The many levels of subjectivity in making a reasonable compensation determination—weighing factors, analyzing comparisons to employees of other companies, determining a reasonable expected rate of return for an independent investor, determining the portion of the company's profitability attributable to the employee's efforts, and determining whether a payment is reasonable for past services—make it a highly unpredictable judgment.<sup>109</sup>

#### IV. INTERPLAY OF THE HIGHLY SUBJECTIVE DETERMINATION OF REASONABLE AMOUNT WITH THE FORMULATION OF THE INTENTS TO GIFT AND TO COMPENSATE

##### A. Intent to Compensate

The taxpayer has sometimes been bound by an original characterization, indicating an intent to compensate.<sup>110</sup> His deduction of the amount as compensation expense on his income tax return demonstrates the intent.<sup>111</sup> The Court of Claims argued in *Sterno Sales Corp. v. United States* that

[C]ompensation remains compensation even if it is held unreasonable in amount and, accordingly, not deductible as a business expense. The

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take advantage of the favorable situation and for a few years receive liberal compensation. But it was still compensation for personal services, and of a kind that was entitled to liberal compensation when the results were sufficiently successful to pay it.

*Id.*

<sup>107</sup>*Exacto Spring Corp.*, 196 F.3d at 839.

<sup>108</sup>*R.J. Nicoll v. Commissioner*, 59 T.C. 37, 50 (1972), *acq.* 1973-1 C.B. 2 (citing *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115, 119 (1930)). The *Lucas* court explained that the payments for past services were incurred in the year of payment because there were no prior agreements to pay or legal obligation to pay these amounts. There was nothing in the tax law to preclude payment in a later year based on an internal policy decision to reward earlier efforts. *Lucas*, 281 U.S. at 119 (1930).

<sup>109</sup>*Exacto Spring Corp.*, 196 F.3d at 835.

<sup>110</sup>*E.g.*, *Sterno Sales Corp. v. United States*, 345 F.2d 552, 556 (Ct. Cl. 1965).

<sup>111</sup>*Willke v. Commissioner*, 127 F.2d 953, 956 (6th Cir. 1942).

payment does not change in character solely because it is characterized as excessive or undue. The non-deductibility of the expense by the payer, because it is unreasonable in amount, does not transform the payment in the hands of the payee.<sup>112</sup>

But later in the same opinion, the court states, in what appears to be a contrary stance, “If such payments are not true compensation they must, of course, be treated as what they actually are; presumably, that is what the Commissioner will insist on doing.”<sup>113</sup> Notwithstanding this statement, the court held “that all the payments to Sterno Sales in 1951 must be treated as they have up to now been by all the parties, as compensation and therefore as includible in gross income under the wide reach of Section 22(a) of the 1939 Code.”<sup>114</sup> The court’s concern in forbidding claims by the taxpayer that the payment should be recharacterized as other than compensation appears to be the potential tax benefit that could arise from the recharacterization.<sup>115</sup> Examples might include the reduction of payroll tax liabilities, treatment of compensation as a non-taxable S corporation dividend, treatment of a payment to a family member as an excludable gift, or treatment as a contribution of capital to a related corporation, as was the case in *Sterno Sales v. United States*. “[T]he Regulations do not suggest that payments which have hitherto been considered by everyone (including the Service) to be compensation, though in excess of reasonable compensation, can or may be treated as of another character by the recipient in order to gain a tax advantage for himself.”<sup>116</sup> This implies that the taxpayer could deliberately attempt to deduct excessive salary payments, hoping they would not be challenged, because this characterization renders the best tax result for the payment. If payments are challenged, he could change his characterization to, say, a dividend to the owner followed by a gift to the recipient. This creates a better result than if the payment were compensation, with the excess portion treated as non-deductible.

The inherent unfairness in applying this prohibition on a taxpayer’s substance over form argument in reasonable compensation cases stems from the extreme subjectivity of the reasonableness determination, which prevents the taxpayer from knowing in advance what portion of his payment the government will determine to be reasonable. As the *Exacto* court noted, “because the reaction of the Tax Court to a challenge to the deduction of executive compensation is unpredictable, corporations run unavoidable legal risks in determining a level of compensation that may be indispensable to the success of their business.”<sup>117</sup> An employer’s determination of an appropriate amount of compensation could be based on his own good faith, subjective judgment of reasonableness. Although all the relevant facts

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<sup>112</sup>*Sterno Sales Corp.*, 345 F.2d at 554.

<sup>113</sup>*Id.* at 556-57. (The dissent attacked the majority opinion for shirking its duty to determine the true character of the excessive compensation payments: “I believe that it is up to this court to decide whether such excessive payments were, in effect, a distribution of earnings and profits.”) *Id.*

<sup>114</sup>*Id.* at 556.

<sup>115</sup>*Id.* at 554, 556.

<sup>116</sup>*Id.* at 556.

<sup>117</sup>*Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 835 (7th Cir. 1999).

were available to him at the time of the payment, the government's subjective analysis was not. Thus, the subjectivity removes the assumption of deliberate abuse that the court's opinion is apparently intended to curb. Therefore, the originally indicated intent to compensate should be subject to re-evaluation. At the time the intent to compensate was indicated, the taxpayer could not reasonably be expected to foresee the government's subsequent determination that a reasonable person would not have paid that amount as salary. In an equally subjective context, however, the courts have consistently acknowledged the right of the taxpayer to argue substance over form to assert a step transaction theory.<sup>118</sup>

[W]ithout regard to whether the result is imposition or relief from taxation, the courts have recognized that where the essential nature of a transaction is the acquisition of property, it will be viewed as a whole, and closely related steps will not be separated either at the instance of the taxpayer or the taxing authority.<sup>119</sup>

The government's determination that compensation while unreasonable is in fact compensation is essentially a poor act of recharacterization, because it does not follow the facts as presented. A substance over form argument by the taxpayer is an equitable response proposing recharacterization of the government's newly asserted position. Where the taxpayer's compensation deduction was intentionally abusive, and the specific circumstances indicate that there is truly no better characterization for the payments than excessive compensation, the taxpayer's substance over form argument will likely fail on its merits.

"Reasonable" is defined as what is "[f]air, proper, just, moderate, suitable under the circumstances."<sup>120</sup> Unreasonable compensation, then, is that which exceeds the value of the services rendered. "[R]easonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."<sup>121</sup> The definition of "compensation" in all of its various contexts centers around the notion of equivalency.

[M]aking whole . . . giving an equivalent or substitute of equal value. That which is necessary to restore an injured party to his former position . . . . Equivalent in money for a loss sustained; equivalent given for property taken or for an injury done to another; giving back an equivalent in either money which is but the measure of value, or in actual value otherwise conferred."<sup>122</sup>

When payment is determined unreasonable, the requisite equivalency between payment and services is lacking. The payment fails to compensate, by definition,

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<sup>118</sup>Robert Thornton Smith, *Substance and Form: A Taxpayer's Right to Assert the Priority of Substance*, 44 TAX LAW. 137, 151 (1990). "[S]tep transaction doctrine . . . seeks to treat a series of formally separate steps as a single transaction." *Id.* at 150-151.

<sup>119</sup>*Id.* (citing *Commissioner v. Ashland Oil and Refining Co.*, 99 F.2d 558, 591 (6th Cir. 1938)).

<sup>120</sup>BLACK'S LAW DICTIONARY 874 (6th ed. 1991).

<sup>121</sup>Treas. Reg. § 1.162-7(b)(3) (1960).

<sup>122</sup>BLACK'S LAW DICTIONARY 194 (6th ed. 1991).

notwithstanding an intent to compensate. Therefore, it must be recharacterized as other than compensation.

*B. Intent to Gift*

In cases where the taxpayer has argued that the disallowed unreasonable portion of a compensation payment is a gift, the courts have discredited the claim based on the notion that an element of a gift is lacking, i.e., the intent of the donor to make a gift.<sup>123</sup> An example of such a case is *Smith v. Manning*.<sup>124</sup> Because the taxpayer in this case held out that payments to his daughters were salaries by 1) stating that they were compensation at the time the payments were made, 2) by deducting them as salaries on his income tax return, and 3) by maintaining that view to the Internal Revenue Service and the Tax Court, the court held that the payments were made “without a donative intent.”<sup>125</sup> *Willke v. Commissioner* simplified the parameters of the gift versus compensation distinction, holding that the taxpayer’s deduction for compensation negates the intent to make a gift.<sup>126</sup> In both of these cases, because the original transaction displayed an intent to compensate, there was no recharacterization. The court treated the unreasonable payment as a disallowed compensation expense and the income as compensation income to the original recipient.

In each case, the original statement of intent occurred prior to the government’s determination of reasonableness. Given the subjectivity of that judgment, the taxpayer should have had an opportunity to reconsider an intent as if the determination were available at the time of the payment. Had the taxpayer known the prescribed limits on reasonable compensation, he might have made the payment gratuitously, based on impulses of affection, respect, charity, or the like that are intrinsic to a gift.<sup>127</sup> Furthermore, the payment of the unreasonable portion would be made with the requisite lack of consideration of a gift<sup>128</sup> because it was determined that there was no exchange for value of services.

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<sup>123</sup>*Id.* at 473. *Black’s* defines a gift as:

A voluntary transfer of property to another made gratuitously and without consideration. Essential requisites of gift are capacity of donor, intention of donor to make gift, completed delivery to or for the donee, and acceptance of gift by donee. In tax law, a payment is a gift if it is made without conditions, from detached and disinterested generosity, out of affection, respect, charity, or like impulses, and not from the constraining force of any moral or legal duty or from the incentive of anticipated benefits of an economic nature.

*Id.*

<sup>124</sup>189 F.2d 345, 348 (3d Cir. 1951).

<sup>125</sup>*Id.*

<sup>126</sup>*Willke v. Commissioner*, 127 F.2d 953, 956 (6th Cir. 1942). (“The fact that the corporate payor claimed the present payment as a deduction at arriving at its taxable net income for the year in question is regarded as an intent to pay compensation for services rather than to make a gift.”). *Id.*

<sup>127</sup>BLACK’S LAW DICTIONARY 473 (6th ed. 1991).

<sup>128</sup>*Id.*

The failure to recharacterize in *Smith v. Manning* and *Willke v. Commissioner* is consistent with the *Sterno Sales Corp. v. United States* court's holding that considered the Court of Claims bound by the characterization of the parties.<sup>129</sup> Judge Davis, writing for the majority, looked no further than the original transaction to support or discredit that characterization.<sup>130</sup>

The courts have reclassified compensation as a payment out of generosity following a constructive dividend payment to the owner. In *Montgomery Eng'g Co. v. United States*, the Third Circuit recharacterized salary payments to an officer's widow as a dividend to the surviving stockholder because the payment was made due to a moral obligation, rather than for a business purpose.<sup>131</sup> The circuit court negated the taxpayer's displayed intent to compensate, finding that the facts and circumstances defined a different characterization.<sup>132</sup> This determination achieved a much higher degree of equity than the *Sterno Sales Corp. v. United States* holding. Recharacterization caused the associated tax liabilities to be borne by the appropriate parties in accordance with the true nature of the transaction.

## V. DETERMINATION OF CONSTRUCTIVE DIVIDENDS

### A. Non-Restricted Determination

The distinction between a payment made with respect to the corporation's stock and a payment made for services is not clear. This determination is made on a case by case basis, based on each case's own particular circumstances.<sup>133</sup> A payment can be a constructive dividend, even if it is not formally declared,<sup>134</sup> not paid to a

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<sup>129</sup>*Sterno Sales Corp. v. United States*, 345 F.2d 552, 554 (Ct. Cl. 1965).

<sup>130</sup>*Id.* at 557.

<sup>131</sup>*Montgomery Eng'g Co. v. United States*, 344 F.2d 996, 997 (3d Cir. 1965).

<sup>132</sup>*Id.* See also *Garrison v. Commissioner*, 52 T.C. 281, 285 (1969)

[E]xcessive compensation does not, as a matter of law, retain that characterization for tax purposes in the hands of the recipient. Nor must it necessarily be considered something other than compensation. Neither the label initially affixed by the taxpayer nor the failure of the respondent to provide an alternative for the disallowed payment is conclusive. The touchstone for decision is a factual determination as to the actual nature of the payment in question under all the circumstances, free from any compulsory inhibitions stemming from the designations of the parties.

*Id.*

<sup>133</sup>*Garrison*, 52 T.C. at 285. ("Whether or not a corporate distribution is a dividend or something else, such as a gift, compensation for services, repayment of a loan, interest on a loan, or payment for property purchased, presents a question of fact to be determined in each case.").

<sup>134</sup>*Kennington Realty Co. v. Commissioner*, 8 B.T.A. 1030, 1035 (1927). (The *Kennington Realty Co. v. Commissioner* court held that payments that were not made as a result of corporate action declaring a dividend were in fact dividends. It noted a presumption of corporate authorization where distributions were computed and paid by an officer of a close corporation that was controlled by one man.). *Id.*

shareholder,<sup>135</sup> not pro rata to stock ownership,<sup>136</sup> or not a distribution under state law.<sup>137</sup> “The hallmark of a constructive distribution is value passing from, or a sufficiently specific economic benefit conferred by, the corporation to the shareholder, for which the shareholder does not give equivalent value in exchange.”<sup>138</sup>

While payments of dividends need not be pro rata, proportionality of payments to stockholdings can, nonetheless, be indicative of a distribution. Treasury Regulation section 1.162-7(b)(1) suggests dividend potential where payments “are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees.”<sup>139</sup>

#### B. Failure to Pay Dividends

A corporation’s failure to pay dividends can further implicate compensation payments as disguised dividends. Rev. Rul. 79-8 repudiated the former automatic dividend rule, under which dividends are necessarily implied from the failure of the corporation to pay more than insubstantial dividends,<sup>140</sup> in support of decisions subsequent to *Charles McCandless Tile Ser. Co. v. United States*.<sup>141</sup> Nonetheless,

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<sup>135</sup>*Montgomery Eng’g Co. v. United States*, 344 F.2d at 996 (3d Cir. 1965).

<sup>136</sup>*E.g., Id.*; *Garrison v. Commissioner*, 52 T.C. 281, 286 (1969) (noting that “in the context of dealings between members of a family and their closely held corporation, the non-prorata character of a payment to the shareholders does not, standing alone, preclude characterization of the payment as a dividend.”); *Kennington Realty Co.*, 8 B.T.A. at 1035. In holding that payments were distributions with respect to stock rather than compensation, the court found that the fact that one shareholder received no dividends was immaterial, “since by unanimous agreement of the stockholders, corporations may distribute earnings to stockholders other than ratably on the basis of stock holdings.” *Id.*

<sup>137</sup>*Jaques v. Commissioner*, 935 F.2d 104, 108 (6th Cir. 1991).

<sup>138</sup>BORIS I. BITTKER & JAMES S. EUSTICE, *FED. INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 8.05[1] (7th ed. 2000).

<sup>139</sup>Treas. Reg. § 1.162-7(b)(1) (1960). The *O.S.C. & Assoc’s, Inc. v. Commissioner* court recast admittedly reasonable compensation as a dividend, based on lack of compensatory intent. It used the proportionality of payments, as well as the failure of the corporation to pay any dividends, as indicia of disguised dividend payments. Once these indicia were established, the court reasoned that an inquiry into the existence of compensatory intent was justified. *O.S.C. & Assoc’s Inc. v. Commissioner*, 73 T.C.M. (CCH) 3231 (1997), *aff’d* 187 F.3d 1116 (9th Cir. 1999).

<sup>140</sup>*Charles McCandless Tile Serv. Co. v. United States*, 422 F.2d 1336 (Ct. Cl. 1970) (holding that where purported compensation was reasonable but dividend history was poor, compensation necessarily included distribution of earnings).

<sup>141</sup>Rev. Rul 79-8, 1979-1 C.B. 92. According to the ruling:

The failure of a closely held corporation to pay more than an insubstantial portion of its earnings as dividends on its stock is a very significant factor to be taken into account in determining the deductibility of compensation paid by the corporation to its shareholder-employees. Conversely, where after an examination of all the facts and circumstances (including the corporation’s dividend history) compensation paid to the shareholder-employees is found to be reasonable in amount and paid for services rendered, deductions for such compensation under section 162(a) of the Code will not

courts consistently treat the failure to pay dividends as a significant factor in determining whether questionable payments are reasonable compensation or constructive distributions.<sup>142</sup>

As a defense against the implication that a company's failure to pay dividends renders compensation payments to be disguised dividends, the taxpayer can avail himself of those same defenses of reasonable anticipated needs of the business as are used to negate the imposition of the accumulated earnings tax<sup>143</sup> imposed under Internal Revenue Code section 531.<sup>144</sup> Reasonably anticipated needs of the business must be "specific, definite, and feasible plans for the use of such accumulation."<sup>145</sup> These needs can include such items as adequate working capital and liquidity needs,<sup>146</sup> growth and capital improvement plans,<sup>147</sup> anticipated stock redemption,<sup>148</sup> or contingent liabilities, such as product liability loss reserves.<sup>149</sup> Thus, when evaluating the reasonableness of compensation, just as when evaluating the applicability of a "penalty" tax for not paying dividends, a corporation can defend its failure to pay dividends, and accordingly, its characterization as compensation.<sup>150</sup>

In reviewing the corporation's dividend payment history to do an "independent investor" analysis of reasonableness, the return on investment, which must be at a market rate of return after the salary payment in question, includes not only dividend

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be denied on the sole ground that the corporation has not paid more than an insubstantial portion of its earnings as dividends on its outstanding stock.

*Id.* See also *Edwin's Inc. v. United States*, 501 F.2d 675, 677 (7th Cir. 1974) ("[W]hile the absence of dividends might be a red flag, it should not deprive compensation demonstrated to be reasonable under all of the circumstances of the status of reasonableness.").

<sup>142</sup>*Kennedy v. Commissioner*, 671 F.2d 167, 176 (6th Cir. 1982) ("It is true that non-payment of dividends by a close corporation is a factor which may indicate that compensation is unreasonable . . . however that alone is not determinative."); *O.S.C. & Assoc's, Inc. v. Commissioner*, 73 T.C.M. (CCH) 3231 (1997).

<sup>143</sup>I.R.C. § 531 (West 2001). This is a tax imposed on corporations that have failed to distribute the corporation's earnings and profits in order to avoid shareholder income tax on dividends. Despite a presumption of avoidance, the tax is not imposed where the corporation can prove by a preponderance of the evidence to the contrary that the accumulation does not exceed the "reasonable needs of the business." I.R.C § 533(a) (West 2001).

<sup>144</sup>*KAFKA*, *supra* note 19, at A-4.

<sup>145</sup>Treas. Reg. § 1.537(1)(b) (1986).

<sup>146</sup>*E.g.*, *New England Wooden Ware v. United States*, 289 F. Supp. 111, 117 (D. Mass. 1968).

<sup>147</sup>*Id.*

<sup>148</sup>Treas. Reg. § 1.537(1)(a) (1986).

<sup>149</sup>*Id.*

<sup>150</sup>*E.g.*, *Levenson & Klein, Inc. v. Commissioner*, 67 T.C. 694, 714 (1977) (holding that where cash received on trade accounts receivable was restricted as security for bank notes, leaving only enough unrestricted cash to pay accounts payable and normal business expenses including salaries, the failure to pay dividends did not impact the determination of reasonableness).

payments, but also unrealized appreciation in the value of the stock.<sup>151</sup> Thus, the payment of only small dividends or the failure to pay dividends does not in itself equate to an inadequate return on investment.<sup>152</sup>

The finding of a constructive dividend, i.e., where “the corporation conferred an economic benefit on the stockholder without expectation of repayment,”<sup>153</sup> is not determined by the motive or expressed intent of the corporation.<sup>154</sup> In fact, it may be contrary to the corporation’s expressed intent.<sup>155</sup> The fact that an intent to pay a dividend is not required, coupled with the fact that case law places great flexibility in the determination of dividends, combine to make an easy threshold for a finding of a constructive dividend. The reclassification of excess compensation as a distribution of earnings is mandated where the facts and circumstances indicate that it is a distribution with respect to the stock, i.e., a constructive dividend.<sup>156</sup> Where compensation payments are unreasonable, an economic benefit was conferred on the shareholder; no expectation of repayment in value (i.e., value as determined by the government) of services are expected. Therefore, the payment is a constructive dividend, by definition, and should be recharacterized as such.

#### VI. COMPARISON OF SECTION 162 DEDUCTION LIMITATION TO POLICY-BASED SALARY DEDUCTION LIMITATIONS APPLICABLE TO LARGE, PUBLICLY TRADED COMPANIES

##### A. Golden Parachute Payments

One policy-based limitation on the deductibility of compensation concerns golden parachute payments.<sup>157</sup> A golden parachute is a type of employment contract between a corporation and an executive providing substantial severance pay in the event of a change in corporate control.<sup>158</sup> “[T]he parachute does not open until the

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<sup>151</sup>Home Interiors and Gifts, Inc. v. Commissioner, 73 T.C. 1142, 1162 (1977) (“[W]hen the return to shareholders in the form of dividends and appreciation in the value of their stock was examined, it is apparent that the exceptional prosperity of the company was shared with the stockholders.”). See also Elliott’s Inc. v. Commissioner, 716 F.2d 1241, 1247 (9th Cir. 1983); Trucks, Inc. v. United States, 588 F. Supp. 638, 647 (D. Neb. 1984).

<sup>152</sup>Home Interiors and Gifts, Inc., 73 T.C. at 1148 (holding that compensation was reasonable where the ratio of dividends to net profit declined in years of tremendous growth in sales and profits).

<sup>153</sup>United States v. Smith, 418 F.2d 589, 593 (5th Cir. 1959). The term repayment is reworded in the Bittker definition of constructive dividend as “equivalent value in exchange.” BITTKER ET AL, *supra* note 139, at ¶ 8.05[1].

<sup>154</sup>Smith, 418 F.2d at 593.

<sup>155</sup>*Id.*

<sup>156</sup>BITTKER ET AL, *supra* note 139, at ¶ 8.05[1].

<sup>157</sup>KAFKA, *supra* note 19, at A-18. “The Finance Committee emphasized that it was unwilling to have the tax law used as a ‘subsidy,’ and expressed its intent that such contracts warranted adverse tax consequences.” *Id.* (citing S. Prt. 169, 98th Cong. 2d Sess. 195 (1984)).

<sup>158</sup>KAFKA, *supra* note 19, at A-17.

company experiences some control-altering event.”<sup>159</sup> It can be argued that these contracts can secure some beneficial results, such as the ability to procure and retain high level management personnel who will maintain objectivity and independence.<sup>160</sup> Critics of golden parachute contracts, however, attack them generally on the basis that they unjustifiably subsidize the current management team at the expense of shareholders.<sup>161</sup> Critics argue that the corporation will likely not receive an adequate return on its investment,<sup>162</sup> and that such payments waste corporate assets by unduly compensating executives who are already well paid.<sup>163</sup> Furthermore, payments are often made to dismissed executives or those who resigned, raising the question of how the payments could be related to the employee’s worth and value to the future of the business.<sup>164</sup> Additionally, the proposed benefits of objectivity and independence of the golden parachute payments are no more than what was originally required by the employee’s fiduciary duty to the publicly traded company.<sup>165</sup> Rather than insuring objectivity and independence in management, the payments could actually be functioning to breed complacency.<sup>166</sup> The result of all these concerns is a dichotomy of the interests of management employees and shareholders.

To protect the conflicting interests of shareholders, who bear the cost of golden parachute agreements through either a reduction in return on investment or a reduced tender offer price due to the assumed parachute payment obligation by the acquiring company, Congress enacted Internal Revenue Code sections 280G and 4999.<sup>167</sup> These provisions impose penalty taxes on “excess parachute payments”<sup>168</sup> made only by large corporations with readily tradable stock.<sup>169</sup> Section 280G renders those payments that are calculated to be excess parachute payments non-deductible,<sup>170</sup> while section 4999 imposes a 20 percent excise tax on such payments to the recipient.<sup>171</sup> The full amount of the payments remains salary income to the

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<sup>159</sup>Henry F. Johnson, *Those “Golden Parachute” Agreements: The Taxman Cuts the Ripcord*, 10 DEL. J. CORP. L. 45, 45 (1985) (citing Lynn A. Grisham & Doug Rake, Comment, *Future Executive Bail Outs: Will Golden Parachutes Fill the American Business Skies?*, 14 TEX TECH. L. REV. 615, 616 (1983)).

<sup>160</sup>*Id.* at 48-49.

<sup>161</sup>KAFKA, *supra* note 19, at A-18.

<sup>162</sup>Johnson, *supra* note 160, at 51 (citing William R. Spalding, Note, *Golden Parachutes: Executive Employment Contracts*, 40 WASH. & LEE L. REV. 1117, 1118 (1983)).

<sup>163</sup>*Id.* (citing W. PAINTER, BUSINESS PLANNING 748 (2d ed. 1984)).

<sup>164</sup>*Id.* at 51-52.

<sup>165</sup>*Id.* at 52-53.

<sup>166</sup>*Id.* at 54.

<sup>167</sup>I.R.C. §§ 2806, 4999 (West 2001).

<sup>168</sup>I.R.C. § 280G(b) (West 2001).

<sup>169</sup>I.R.C. § 280G(b)(6). (West 2001).

<sup>170</sup>I.R.C. § 280G(a) (West 2001).

<sup>171</sup>I.R.C. § 4999(a) (West 2001).

recipient.<sup>172</sup> Any compensation payments that are reasonable under section 162 and related to services before the change of corporate control, however, are excluded from treatment as excess parachute payments under sections 280G and 4999.<sup>173</sup>

*B. Limited Executive Compensation Deduction*

A second limitation on the deductibility of compensation paid to key executives of publicly held companies is the \$1,000,000 maximum annual deduction limit per covered individual contained in Internal Revenue Code section 162(m).<sup>174</sup> A “covered individual” is either the chief executive officer of the company<sup>175</sup> or a non-chief executive officer for whom reporting is required under the Securities and Exchange Act of 1934, usually as a result of being one of the four highest paid, non-CEO officers.<sup>176</sup> Commissions and performance-based compensation, however, are not subject to the \$1,000,000 limit.<sup>177</sup>

Each of these two provisions, the golden parachute disallowance and the excess over \$1,000,000 disallowance, maintains an interplay with the reasonableness requirement of section 162(a).<sup>178</sup> An excess parachute payment is reduced by reasonable compensation.<sup>179</sup> Therefore, only unreasonable compensation is disallowed under section 280G and penalized under section 4999.<sup>180</sup> Under section 162(m), however, the excess compensation over \$1,000,000 is disallowed under a statutory determination of per se unreasonableness. But the provisions of section 162(m)(4)(B) and (C), which exclude commissions and performance-based compensation from disallowance,<sup>181</sup> serve to maintain the deductibility of payments that are actually compensation for services. It is only for public policy reasons that these statutory provisions arose,<sup>182</sup> seemingly to curb abuses in corporate activity that

<sup>172</sup>I.R.C. § 61 (West 2001).

<sup>173</sup>I.R.C. § 280G(b)(4)(B) (West 2001) (“[T]he amount treated as an excess parachute payment shall be reduced by the portion of such payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered before the date of the change described in paragraph (2)(A)(i).”).

<sup>174</sup>I.R.C. § 162(m) (West 2001).

<sup>175</sup>I.R.C. § 162(m)(3)(A) (West 2001).

<sup>176</sup>I.R.C. § 162(m)(3)(B) (West 2001).

<sup>177</sup>I.R.C. § 162(m)(4)(B)-(C) (West 2001).

<sup>178</sup>I.R.C. § 162(a)(1) (West 2001).

<sup>179</sup>I.R.C. § 280G(b)(4)(B) (West 2001).

<sup>180</sup>I.R.C. §§ 280G(b)(4), 4999(b) (West 2001).

<sup>181</sup>I.R.C. § 162(m)(4)(B)-(C) (West, 2001) (subparagraph (B) referring to income paid on a commission basis; subparagraph (C) referring to performance-based compensation).

<sup>182</sup>The RIA COMPLETE ANALYSIS OF THE REVENUE RECONCILIATION ACT OF 1993, 705 (Research Administration of America 1993).

Recently, the amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The [Senate Finance] committee believes that excessive compensation will be reduced if the deduction for compensation (other than

were perceived by the legislature to have a detrimental effect on the shareholders of the companies, as well as on the general public.<sup>183</sup> In the spirit of section 162(a), these provisions provide bright line calculations of presumptively unreasonable compensation and render it non-deductible.

The characterization of non-deductible compensation as compensation income to the payee is appropriate in the large, publicly-traded corporation context. Here, the only feasible character of the payment is compensation, because the employer-employee relationship is the only basis for payment. Even if the managers are also shareholders, dividends are always formally declared in the publicly-traded setting and paid pro-rata based on stock ownership. “Constructive dividends generally are a problem limited to closely-held corporations.”<sup>184</sup> There is less opportunity for controlling owners to manipulate the characterization of payments or to divert them to family members for tax avoidance.<sup>185</sup> Furthermore, the large corporation is on notice through the provisions of Internal Revenue Code sections 280G and 162(m) as to how to determine the potentially non-deductible amounts. Except for the reduction to excess parachute payments for reasonable compensation, these provisions do not require a highly subjective judgment of value by the government. They are straight-forward mathematical calculations.<sup>186</sup> Thus, the displayed intent of treating these payments as compensation should be binding because the payments arose exclusively out of the employer-employee relationship, and their classification was made when the potential non-deductible amount could be pre-determined.

The publicly traded setting is clearly distinguishable from the closely held setting, because it virtually lacks the opportunity to make a distribution with respect to the ownership of stock and disguise it as compensation. Furthermore, limitations on compensation payments are driven by different public policy issues. Therefore, recharacterization is not required, as it would be in the closely held setting, to reflect the true nature of the payment. As a matter of fact, it is not even possible. There is simply no appropriate alternative treatment.

## VII. CONCLUSION

Once either the Internal Revenue Service or the courts determine that compensation payments made by a closely held business are unreasonable under section 162, the true, non-compensatory character of the payment must be ascertained. Equity requires that the tax returns of all parties be adjusted accordingly. Such a mandate serves not only to carry out the purpose of section 162, but also to prevent inconsistent results.

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performance-based compensation) paid to the top executives of publicly held corporations is limited to \$1 million per year.

*Id.*

<sup>183</sup>See generally Johnson, *supra* note 160, at 68.

<sup>184</sup>BLACK’S LAW DICTIONARY 331 (6th ed. 1991).

<sup>185</sup>Kropf, Inc. v. United States, 543 F. Supp. 581, 583 (D. Colo. 1982) (“Payments made by closely held corporations to officer-stockholders will be given special scrutiny in order to determine whether the payment constitutes compensation for services or a distribution of profits.”).

<sup>186</sup>I.R.C. § 280G(b) (West 2001) (explaining “excess parachute payment” calculation); I.R.C. 162(m)(1)(West 2001) (explaining “excessive employee remuneration”).

*A. Inconsistencies of Failure to Recharacterize*

The unwillingness of the courts, in some cases, to recast the transaction to its true form has provided numerous inconsistencies. It has created inconsistent results between cases of comparable circumstances.<sup>187</sup> Further, it has provided results inconsistent with the purpose of unveiling disguises.<sup>188</sup> First, it is inconsistent with the language of Treasury Regulation section 1.162-8, which states conditions under which recharacterization is required.<sup>189</sup> Second, the continued characterization of unreasonable compensation as compensation is inconsistent with the finding that no reasonable person could have paid this amount as compensation. Finally, “compensation,” by definition, connotes equivalency.<sup>190</sup> Unreasonable payments lack equivalency to the value of the services performed and, therefore, are inconsistent with the definition of compensation.

Judge Posner, in his concurring opinion in *Piper Aircraft Corp. v. Wag-Aero Corp.*, commented on the importance of consistency of the law. He noted that “[t]he most important function of appellate review is to maintain consistency of the law; if consistency is not a desideratum, the argument for appellate review is weakened.”<sup>191</sup>

*B. Unveiling Disguised Payments*

The intent of the reasonableness restriction of section 162, i.e., to prevent payments of a non-compensatory character from being disguised as compensation in order to create a tax benefit, is demonstrated both through statutory language and through the history of cases in which a section 162 challenge has been raised by the government. Treasury regulations illustrate the heightened scrutiny required for related party transactions<sup>192</sup> as well as defend compensation payments made under good-faith negotiations.<sup>193</sup> Both Treasury Regulations and the Internal Revenue Code address ostensible salary payments that are actually of a different character, requiring that they be treated as what they truly are.<sup>194</sup>

Virtually all reasonable compensation challenges under section 162(a) have occurred in the context of payments by closely held businesses to related parties, that is, parties related either through ownership of the paying company or through a

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<sup>187</sup>*E.g., compare* *Montgomery Eng'g Co. v. United States*, 344 F.2d 996, 997 (3d Cir. 1965), *with* *Sterno Sales Corp. v. United States*, 345 F.2d 552, 554 (Ct. Cl. 1965).

<sup>188</sup>*Sterno Sales Corp.*, 345 F.2d at 554 .

<sup>189</sup>Treas. Reg. § 1.162-8 (1960) (requiring recharacterization of payments in proportion to stockholdings found to be a dividend and of payments for property).

<sup>190</sup>BLACK'S LAW DICTIONARY 473 (6th ed. 1991).

<sup>191</sup>*Piper Aircraft Corp. v. Wag-Aero*, 741 F.2d 925, 937 (7th Cir. 1984). *See also* *Vesco v. Commissioner*, 39 T.C.M. (CCH) 101 (1979) (“We merely hold that respondent’s practice [Commissioner of Internal Revenue] in effect in 1971 should be applied to petitioner on same basis as it is applied to other taxpayers.”).

<sup>192</sup>Treas. Reg. § 1.162-7(a) (1960).

<sup>193</sup>Treas. Reg. § 1.162-7(b) (1960).

<sup>194</sup>I.R.C. § 911(b) (West 2001); Treas. Reg. § 1.162-8 (1960).

family relationship with an owner.<sup>195</sup> It is here that the most blatant opportunities for intentional maneuvering for the taxpayer's benefit exist. The level of scrutiny has consistently dissipated as the strength of the relationship becomes more attenuated.<sup>196</sup> Challenges under section 162(a) to payments in the large, publicly traded sector, which are less susceptible to individual manipulation, have been avoided. Because the public policy concerns surrounding large compensation payments are the primary issue here, as opposed to recharacterization as something other than compensation, sections 280G and 162(m) have been relied upon instead to curb excessive compensation payments.<sup>197</sup>

The failure to challenge S corporation compensation, where distributions most commonly provide tax-free income,<sup>198</sup> supports an intent of unveiling disguised payments from which a tax benefit has been inappropriately derived. In general, an S corporation shareholder has no incentive to pay himself excessive salary. His salary deduction is offset by corresponding income and payroll taxes. Only special S corporation situations in which an undeserved tax benefit might have been achieved, such as application of the maximum tax on earned income<sup>199</sup> or the diversion of income to a family member with a lower marginal rate,<sup>200</sup> have been targets of examination.<sup>201</sup>

Thus, the free rein of Treasury Regulation section 1.162-7 to disallow compensation deemed unreasonable in amount, even if fully intended to compensate,<sup>202</sup> has only been exercised in cases of perceived potential massive abuse accompanying tax benefit.<sup>203</sup> An example is where the owner of a closely held C corporation pays excessive salary for the purpose of avoiding the double level of taxation that generally results from dividend payments, which are non-deductible by the corporation. From this, it could be argued that it is not the intention of section 162 to impose a burden on free enterprise by creating governmentally imposed business judgments. The intention is, rather, to restate disguised transactions in their true character.

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<sup>195</sup>KAFKA, *supra* note 19, at A-5.

<sup>196</sup>*E.g.* Exacto Spring Corp. v. Commissioner, 196 F.3d at 833 (7th Cir. 1999); Harolds Club v. Commissioner, 340 F.2d at 865 (9th Cir. 1965).

<sup>197</sup>*Id.*

<sup>198</sup>I.R.C. § 1368(b)(1); I.R.C. § 1368(c)(1) (explaining tax free distribution to extent of AAA).

<sup>199</sup>I.R.C. § 1348-R (West 2001) (limiting tax rate on earned income (repealed by P.L. 97-34 § 101(c)(1) for tax years beginning after December 31, 1981)).

<sup>200</sup>I.R.C. § 1366(e) (West 2001) (allocating income among family members).

<sup>201</sup>Trucks v. United States 588 F. Supp. at 638 (D. Neb. 1984) (exemplifying both S corporation issues). *See generally* KAFKA, *supra* note 19, at A-36.

<sup>202</sup>Treas. Reg. § 1.162-7(a) (1960) (requiring that payments be both reasonable and intended to compensate in order to be deductible).

<sup>203</sup>KAFKA, *supra* note 19, at A-5.

The courts generally assumed this equitable responsibility. In most cases, they have recast transactions as they have perceived them.<sup>204</sup> The cases that pronounced immutable characterizations inherent in the taxpayer's compensation deductions have generally been involved in compensation versus gift determinations. With an additional burden of proving requisite donative intent in order to recharacterize as a gift, the courts have assumed donative intent incompatible with a compensation deduction. Therefore, courts hold that excessive payments retain their original character as compensation, both to the payer and the recipient.<sup>205</sup>

In eliminating the possibility of recharacterization, however, these gift cases deny the opportunity to re-evaluate and restate the original intent after the subsequent determination of reasonableness is made. Furthermore, the courts fail to entertain the possibility of determining an original intent contrary to the one presented on the tax return. Nor do they entertain treatment as a constructive dividend to the shareholder, which requires no specific intent. A different view was taken, however, in *Montgomery Eng'g v. United States*, where the Third Circuit recharacterized ostensible compensation as a constructive dividend to the shareholder followed by a payment out of moral obligation and generosity to the recipient.<sup>206</sup>

In a non-gift case, *Sterno Sales Corp. v. United States*, the Court refused to consider recharacterization of unreasonable compensation as a dividend, contrary to language in the case averring that a payment should be treated as what it truly is.<sup>207</sup> Despite a result inconsistent with its own mandates, *Sterno Sales Corp v. United States* has not been overruled.

Those cases in which the true character of the transaction has been considered and restated provide a more equitable result to the parties by allowing innocent differences in judgment as to the reasonable amount to be corrected and by restating tax liabilities as they would have been if the true nature of the transaction had been originally portrayed.

### C. Evidence of Restated Intent

The failure to recharacterize unreasonable compensation payments to their true nature prevents the tax consequences of the transaction from falling consistently with its economic substance. A correct recharacterization of an unreasonable

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<sup>204</sup>*E.g.*, *Montgomery Eng'g Co. v. United States*, 344 F.2d 996, 997 (3d Cir. 1965) (reclassifying as a gift); *Thomas v. Commissioner*, 135 F.2d 378, 379 (5th Cir. 1943) (reclassifying gift as compensation); *Kennedy v. Commissioner*, 671 F.2d 167, 176 (6th Cir. 1982) (reclassifying as a dividend); *Garrison v. Commissioner*, 52 T.C. 281, 285 (1969) (reclassifying as a liquidating dividend); *Quarrier Diner, Inc. v. Commissioner*, 22 T.C.M. (CCH) 276 (1963) (reclassifying as dividend to shareholder, not recipient); *Kennington Realty Co. v. Commissioner*, 8 B.T.A. 1030 (1927) (reclassifying as a dividend).

<sup>205</sup>*E.g.*, *Smith v. Manning*, 189 F.2d 345, 348 (3d Cir. 1951); *Willke v. Commissioner*, 127 F.2d 953, 956 (6th Cir. 1942); *Walker v. Commissioner*, 88 F.2d 61 (1st Cir. 1937); *Fisher v. Commissioner*, 59 F.2d 192 (2d Cir. 1932).

<sup>206</sup>*Montgomery Eng'g Co.*, 344 F.2d at 997.

<sup>207</sup>*Sterno Sales Corp. v. United States*, 345 F.2d 552, 556 (Ct. Cl 1965) ("If a payment originally labeled compensation is determined to be a dividend, the taxpayer (or other affected taxpayer) may well be able to get whatever benefits may lie in that re-evaluation. They can take the Government or the Court at its word.")

compensation payment requires the taxpayer's ability to introduce evidence regarding his intent, with the ability to re-evaluate it in light of the government's highly subjective determination of reasonableness. In certain situations, he should be able to determine if he would have paid the excess amount anyway as a gift following a constructive ownership distribution.<sup>208</sup> As an example, the Third Circuit supported this re-examination of intent when it determined that payments characterized as compensation were actually made out of moral obligation and generosity, and were thus a constructive dividend to the owner.<sup>209</sup> Treasury Regulation section 1.162-8, which mandates recharacterization in certain situations, states that "[i]n the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in the gross income of the recipient."<sup>210</sup> Thus, the regulation implies the right of the taxpayer to introduce evidence regarding the substance of the transaction.

The *Sterno Sales Corp. v. United States* court argued that the taxpayer is not permitted to assert a substance over form argument to recharacterize his transactions, because to do so would permit him to pay a tax resulting from his chosen form or any other form, whichever is less.<sup>211</sup> It implies a prohibition on bad faith changes of position in order to gain a tax advantage. The element that the court is missing, however, is the subjectivity of the reasonableness determination that makes it an unpredictable judgment when the transaction is originally characterized.<sup>212</sup> Therefore, what the court is challenging under the guise of bad faith can quite easily be merely a legitimate difference in judgment. The court states that the government should determine the true nature of the transaction and cast it accordingly.<sup>213</sup> However, if it fails to do so, as it did in this case,<sup>214</sup> the taxpayer has no recourse in raising his own argument of substance over form.<sup>215</sup> If, on the other hand, the original transaction had been characterized in bad faith by the taxpayer for tax avoidance, it is unlikely that the taxpayer's evidence would be sufficient to recast the transaction in contradiction to its true substance.

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<sup>208</sup>*E.g., Id.; Contra, e.g., Smith v. Manning*, 189 F.2d 345 (3d Cir. 1951).

<sup>209</sup>*Montgomery Eng'g Co.*, 344 F.2d at 997.

<sup>210</sup>Treas. Reg. § 1.162-8 (1960).

<sup>211</sup>*Sterno Sales Corp.*, 345 F.2d at 554 (citing *Television Indus. Inc. v. Commissioner*, 284 F.2d 322, 325 (2d Cir. 1960)).

<sup>212</sup>*Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 835 (7th Cir. 1999).

<sup>213</sup>*Sterno Sales Corp.*, 345 F.2d at 554.

<sup>214</sup>*Id.* at 557 (Laramore, J.,dissenting).

The Tax Court did not have to and, in fact did not determine the character of the excessive portion of the payments in the hands of the recipient . . . . I believe that it was up to this court to decide whether such excessive payments were, in effect, a distribution of earnings and profits . . . .

*Id.*

<sup>215</sup>*Id.* at 556 ("But where, as here, it is the taxpayer alone who seeks to impugn his own transaction for his own tax benefit, the courts will not pay heed.").

*D. Constructive Dividend Treatment*

A recharacterization of unreasonable compensation as a constructive dividend is likely when “the corporation conferred an economic benefit on the stockholder without expectation of repayment.”<sup>216</sup> There is no requirement of an intent to pay a dividend.<sup>217</sup> As a matter of fact, the payment of a dividend can be contrary to the corporation’s expressed intent.<sup>218</sup> Courts have consistently held that a dividend can be construed in the closely held setting despite lack of formality in declaration and despite lack of pro rata payment based on stockholdings.<sup>219</sup> Therefore, the payment of unreasonable compensation in the corporate setting often defaults to the payment of a constructive dividend.<sup>220</sup>

*E. Unjust Enrichment*

The failure to restate unreasonable compensation in its true character provides an opportunity for unjust enrichment by the government and by the constructive (but not actual) recipient of the unreasonable compensation by maintaining tax treatments that do not reflect the economic reality of the transaction. The gamut of taxes that could be affected by a recharacterization include income taxes,<sup>221</sup> payroll taxes,<sup>222</sup> and gift transfer taxes.<sup>223</sup> The net tax burden without recharacterization could increase for the taxpayer making the payment when compared to a recharacterized counterpart. For example, payroll tax liabilities remain attached to the unreasonable portion. The recipient’s liability, on the other hand, could be reduced through recharacterization if the income were truly non-taxable. For example, a gift from a constructive recipient, or a non-taxable distribution from an S corporation. In addition to these income tax savings, employee payroll tax liabilities would decrease on the portion of the payment that is recharacterized as other than compensation. Recharacterization could also shift the tax burden from the actual recipient to a constructive recipient, potentially increasing both his income tax and his gift tax liabilities.

The taxes received by the government are likely to be higher when it fails to recharacterize. It collects employer and employee payroll taxes on the full amount, and the income portion always retains its fully taxable character. An exception

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<sup>216</sup>United States v. Smith, 418 F.2d 589, 593 (5th Cir. 1959).

<sup>217</sup>*Id.*

<sup>218</sup>*Id.*

<sup>219</sup>Kennington Realty Co. v. Commissioner, 8 B.T.A. 1030, 1035 (1927).

<sup>220</sup>Kennedy v. Commissioner, 72 T.C. 793, 806 (1979) (“Since petitioners have failed to prove that the excessive payments were part of a reasonable compensation allowance, and since no other reason for the payments exists, we must view the excess received as a distribution of earnings and profits.”).

<sup>221</sup>I.R.C. § 61 (West 2001) (imposing tax generally on gross income); I.R.C. § 162(a)(1) (West 2001) (including reasonable salaries as ordinary and necessary business expenses).

<sup>222</sup>I.R.C. § 3121(a)-(b) (West 2001) (defining wages and employment for FICA and Medicare tax purposes).

<sup>223</sup>I.R.C. § 2501 (West 2001) (imposing gift tax).

would be where an additional gift tax liability resulting from recharacterization, combined with the income and payroll tax liabilities, exceed the combined income tax and payroll tax liabilities of the transaction without recharacterization. Regardless of whose tax liability is benefited and whose is burdened in the recharacterization, and regardless of whether the U.S. Treasury is enriched or diminished, equity demands that the tax liabilities should fall based on the true substance of the transaction.

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