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Excessive Salaries in a Closely Held Corporation

Donald J. Zinner*

EXCESSIVE' SALARIES paid by a closely held corporation create a constant debate between the "owners" of the entity and the Internal Revenue Service, and with other corporation members. The basic law as to the tax aspects underlying the controversy, in the Internal Revenue Code of 1954, is substantially as follows: The compensation claimed as a deduction must be reasonable in amount, and must be paid purely for services. Distributions of profits under the guise of salaries are not deductible.¹

The above Code section, like most tax law sections, leaves much latitude for interpretation, since it lacks definite legal postulates. On the question of excessive compensation to the officers of a closely held corporation, the taxpayer—"owners" usually regard all compensation as reasonable salary for services rendered, and the Internal Revenue Service determines what portion is reasonable compensation and what is in reality a dividend. The reason for this conflict is grounded in the taxpayer's desire to pay less tax. When a corporation pays out compensation in the form of a salary, it is taxable income to the individual who receives it, but it is a deduction for the corporate taxpayer which results in a lower corporate tax. If the compensation is a dividend, in contrast to a salary, it will still be taxable income to the one who receives it, but it is no longer a deduction for the corporation. This crucial issue leads to the question: What does the word *reasonable* salary mean in the framework of a closely held corporation?

The closely held corporation is a unique creature of our society. Compared with corporate giants like General Motors, Ford, and American Telephone & Telegraph, the closely held corporation is usually no more than a sole proprietorship or family or small partnership striving to obtain the legal benefits available to a corporation. It is usually of a non-public nature with the minimum number of legal owners and directors, and often is a family enterprise.

What is *reasonable* depends on the facts and circumstances of each case.² There is no single concept that can tell us if a man is being paid a reasonable compensation for his services. The court decisions in the area are voluminous, and the reasons behind such decisions are just as numerous.

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¹ Int. Rev. Code of 1954, § 162. As to the corporation law and members' views, and also various tax aspects, see, 2 Oleck, *Modern Corporation Law*, c. 43 (§§ 998-1023) (1959, with 1965 suppl.).

² 33 Am. Jur. 2d *Federal Taxation*, § 3130 (1968). And see Oleck, *op. cit. supra*.

An individual can pay another or himself any salary he desires, but it must fall into the realm of the Internal Revenue Service's reasonable salary definition for it to be treated as such by the IRS. The burden of proof as to what is reasonable compensation is on the taxpayer.³

Once the Internal Revenue Service has questioned the reasonableness of a salary, the taxpayer can either settle with the Service or begin his battle in the courts. The basic premise is as follows: If the salary received was deserved, then it is reasonable. This is a general postulate, but its simplicity can be a fatal error. To say what an individual's life work is worth in a monetary figure is not an easy task. The courts start with the theory that in the average corporation the people connected with it are in the best position of anyone to know what salary is reasonable and what is not; and the Commissioner of Internal Revenue is not justified in setting aside this judgment unless he is convinced it is without foundation.⁴

Once the case is at the judicial level the courts must evaluate the many diverse facts and decide the ultimate question of whether the salary is reasonable. In the small, closely held corporation there is the unique situation that one or two employees, usually the major or perhaps only stockholders, make all the major decisions and truly are the integral keys to the corporate structure. The courts must then decide just how much these key employees are worth. In one case the court decided in favor of the taxpayer because he could have earned as much (if not more) outside of the particular business.⁵ Along this line, the courts have decided that the reasonable compensation test be applied to the compensation paid to the particular individual and not to the total salaries paid to a group of individuals performing like services.⁶

The duties of, and the time spent by, the employees are definitely the two most important factors influencing decisions, but they are not the only ones. A very questionable area is the use of the bonus system. This arises when the corporation decides to pay a year-end bonus to an officer, which is normally done when the corporation has had an exceptional year. In these cases the corporation likes to believe it is rewarding its officers for doing an excellent job, but the Internal Revenue Service may believe that the corporation is trying to disguise a dividend as salary. The courts will look to a pattern of prior year's bonus payments and for an authentic bonus plan, in the corporate minutes, in order to answer the reasonableness question.⁷ Probably the best argu-

³ *Palmetto Pump & Irrigation Co. v. L. W. Tomlinson*, 313 F. 2d 220 (5th Cir. 1963).

⁴ *Gordy Tire Co. v. U.S.*, 296 F. 2d 476 (U.S. Ct. Claims, 1961).

⁵ *William S. Gray & Co. v. U.S.*, 35 F. 2d 968 (U.S. Ct. Claims, 1925).

⁶ *L. Schepp Company v. Commissioner*, 25 B.T.A. 419 (1932).

⁷ *Mayson Mfg. Co. v. Commissioner*, 178 F. 2d 115 (6th Cir. 1949).

ment for a well defined bonus system is that it tends to stimulate people to work harder.⁸

The services rendered for the bonus are major factors in most cases. The court will also study any other facts which pertain to the issues. In fact, in one case the court's decision involved the idea of good faith. The good faith doctrine encompasses the concept that the salary is paid for the purpose of compensating one for services actually rendered, and not as an attempt solely to alleviate the corporate tax burden. This doctrine must be based on a good faith business judgment.⁹

The net income of the business is another element for consideration. The Internal Revenue Service wants the officers to be paid in a fair and equitable manner, but not so as to allow the corporate profits to escape corporate taxation by paying them out as salaries. When profits rise and officer duties remain constant, the Internal Revenue will look unfavorably on a great increase in salary.¹⁰ The amount of profit in a business is not the sole or overriding factor, but it can be one of the major elements to be considered. It is conceded that people should be rewarded for success.¹¹ Also, if the salaries are based solely on the ratio of stockholdings, it becomes incumbent upon the taxpayer to satisfactorily show that the compensation was in payment for services actually rendered and are reasonable in amount.¹²

Each year's compensation basically stands autonomously as far as reasonableness is concerned.¹³ Generally though, a previous year's salary will be taken into consideration for comparative purposes.¹⁴ If the current year's salary includes a payment for services rendered in prior years, it should be labeled as such in the corporate minutes.¹⁵ This additional compensation, though made for services rendered in previous years, is deductible from the income of the taxable year in which it was allowed and paid if there was neither prior arrangement nor legal obligation to pay it.¹⁶ A corporation easily may overstep the boundaries when paying for past services. There is one case in which a closely held corporation president suffered a stroke, resulting in paralysis and loss of power of speech, in the year 1949, and the corporation continued to pay him a \$30,000.00 salary in each of the following two years and a salary

⁸ William S. Gray & Co. v. U.S., *supra* note 5.

⁹ Mayson Mfg. Co. v. Commissioner, *supra* note 7.

¹⁰ Pacific Grains, Inc., § 67,007, P-H Memo T.C. (1967).

¹¹ New York Talking Machine Company and Chicago Talking Machine Company v. Commissioner, 13 B.T.A. 154 (1928).

¹² *Ibid.*

¹³ Glenshaw Glass Company, Inc. v. Commissioner, 13 T.C. 296 (1949).

¹⁴ Ridgewood Provisions, Inc. v. Commissioner, 6 T.C. 87 (1946).

¹⁵ Lydia E. Pinkham Medicine Co. v. Commissioner, 128 F. 2d 986 (1st Cir. 1942).

¹⁶ Lucas, Commissioner v. Ox Fibre Brush Company, 281 U.S. 115 (1930).

of \$24,000.00 the third year. The court held that a reasonable sum would not be over \$10,000.00.¹⁷ This was an example of the court truly determining the monetary value of a man's services.

Another problem that appears in these cases is compensation on a contingent basis. This type of salary is similar to the bonus system and is usually based on a percentage of sales or profits. The court will look to the circumstances existing at the date when the contingent contract for services was made, and not those existing at the date when the contract is questioned.¹⁸

As has been previously stated, each case must be decided on its own merits. Because of this, cases have been decided for many diverse reasons. One court has held that merely being a director of a corporation is not enough to justify a large salary.¹⁹ Another important area concerns the employee who divides his time between two or more corporations. If the corporations are both closely held, the Internal Revenue Service might tend to combine the salaries into one.²⁰ Within the same corporation there might be an employee who is doing two jobs. This does not mean that he can receive a double salary, but he does deserve a higher compensation than if he is just doing one job. The test is the extent of responsibility.²¹

The fact that a closely held corporation is frequently a family corporation often presents the reasonable salary problem. In these cases the Internal Revenue Service will try to ascertain whether the salary is being paid in an "arms length" transaction. In a 1953 case an officer's wife was paid \$2,500.00 for being Secretary-Treasurer. The wife had no office space and had signed the same documents as she had the previous year, when she received no compensation. The court held that \$1,200.00 was a reasonable salary.²² In another case where salary was paid to a son, the court examined the corporation's prior salary scales and also compared the son's salary to other people within the company with similar duties.²³

Courts consider various criteria to determine the reasonableness of salaries. First, they will compare salaries with a corporation of about the same size and of the same complexity. This should be done within the same or a very similar industry.²⁴ When making this comparison they will look to see whether the officers might be doing work above and

¹⁷ *Perel and Lowenstein Inc. v. Commissioner*, 237 F. 2d 908 (6th Cir. 1956).

¹⁸ *California Vegetable Concentrates, Inc. v. Commissioner*, 10 T.C. 1158 (1948).

¹⁹ *Express Publishing Co. v. Commissioner*, 143 F. 2d 386 (5th Cir. 1944).

²⁰ *The Sheild Company, Inc. v. Commissioner*, 2 T.C. 763 (1943).

²¹ *Stuetzer, Jr., Reasonable Compensation*, N.Y.U. Twenty-fifth Annual Institute on Federal Taxation, 491 (1967).

²² *East Coast Equipment Company v. Commissioner*, 21 T.C. 112, 122 (1953).

²³ *Sohmer & Co. Inc. v. U.S.*, 86 F. Supp. 670 (S.D.N.Y. 1949).

²⁴ *Stuetzer, Jr., op. cit. supra* note 21.

beyond what others in the same industry are doing.²⁵ Second, the courts frequently look at prior salary payments as a guide. An established plan is always more favorable than a random method.²⁶ Third, the courts will look at the dividend policy in order to ascertain if the corporation is paying out all compensation in salaries or is paying a fair share as dividends. The Internal Revenue Service has the right to say that the salary portion which they determine to be excessive is in fact a dividend if it can be so proved.²⁷ Fourth, the courts will consider general economic conditions, such as inflation, deflation or war times.²⁸

The courts must review all the facts from the amount of work the employee does to the economic conditions of the period. But it is the responsibility of the Internal Revenue Service to establish that the salary was not reasonable. The Court of Appeals is without power to make findings of fact, as its function is to determine whether the Tax Court's decision is in accordance with the law.²⁹ If the taxpayer offers believable evidence as to reasonableness, and the government offers no evidence to contradict the taxpayer's evidence, the courts generally hold that the compensation claimed as a deduction must be upheld.³⁰ Therefore, when the Internal Revenue Service produced no witnesses to show that compensation was unreasonable, this weakened their case.³¹ Even the use of experts is only one factor to be considered. Their object is merely to give the court the benefit of the opinion of persons who have special knowledge in the particular field.³² The court cannot disregard unimpeached, uncontradicted testimony from well-qualified, impartial witnesses.³³

We have seen why the officers of a corporation prefer a salary over a dividend, and we have reviewed the major elements of the excessive salary type case. The question before us now is: Where is the law at present and what direction will the law take in the future? First, the taxpayer, being quite aware of the excessive salary provisions, is attempting to open new avenues. He now realizes that there are other methods to pay one for services besides a monetary salary. Some corporations are attempting to give bonuses in property or stock.³⁴ Another of the so-called popular methods is the fringe benefit plan. A

²⁵ *Ibid.*

²⁶ *Id.*

²⁷ *Twin City Tile & Marble Co. v. Commissioner*, 32 F. 2d 229 (8th Cir. 1929).

²⁸ *Stuetzer, Jr., op. cit. supra* note 21.

²⁹ *Patton v. Commissioner*, 168 F. 2d 28 (6th Cir. 1948).

³⁰ *Polak's Frutal Works, Inc. v. Commissioner*, 21 T.C. 953 (1954).

³¹ *Mayson Mfg. Co. v. Commissioner, supra*, note 7.

³² *Wenatchee Bottling Works v. Henrichsen*, 31 F. Supp. 763 (S.D. Wash. 1940).

³³ *Roth Office Equipment Co. v. Gallagher*, 172 F. 2d 452 (6th Cir. 1949).

³⁴ 33 Am. Jur. 2d, *Federal Taxation* § 3150 (1968).

prime example is where a corporation pays one's health and accident insurance. The I.R.S. Regulations of the 1954 Internal Revenue Code do not say that such fringe benefits must be reasonable, but they state that the benefits must be ordinary and necessary expenses of the business. At first glance this might appear to be a loophole in the law, but the Sixth Circuit has stated that the element of reasonableness is inherent in the phrase "ordinary and necessary."³⁵ In the area of fringe benefits, one must further note that the widely used pension and profit sharing plans must be reasonable in amount after being added to all compensation.³⁶ The problem in the area of the fringe benefits lies in the future. The courts must decide if the benefits plus the monetary salary are reasonable.

The "Legal Aspects of Excessive Salaries in a Closely Held Corporation" is a subject of Internal Revenue pronouncements on the law and the Federal Court's interpretation of the laws. The Internal Revenue Code of 1954 states, in Section 162:

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 of business, including—

- (1) A reasonable allowance for salaries or other compensation for personal services actually rendered.³⁷

It is for the courts to decide what this reasonable allowance is. At first glance it appears the courts are deciding what a man can earn, but this is not necessarily true. What the courts are doing is telling a man what amount of his compensation will be taxed at the individual level, and what amount is also subject to the corporate tax. The justification for this must be that the corporation is a creature of the government, and it is, therefore, the government which has the right to set the tax structure.

Generally, it can be seen that the courts are more liberal than the Internal Revenue Service in allowing salaries above what Internal Revenue Service deems excessive.³⁸ In four cases decided in 1967 this liberal policy can be seen. In the first case, the courts stated that the true test for deductibility is whether the services performed are worth the pay, not how much time it took to perform the services, and, therefore, allowed a \$10,000.00 salary for vital part-time work.³⁹ In the second case, the court allowed a salary and bonus of \$60,000.00 to a Chevrolet dealer. The court stated that the president had taken over

³⁵ Commissioner v. Lincoln Electric Co., 176 F. 2d 815 (6th Cir. 1949).

³⁶ Int. Rev. Code of 1954, Regs. 1.404 (a)-1(b).

³⁷ Int. Rev. Code of 1954, § 162(c) (1954).

³⁸ 33 Am. Jur. 2d Federal Taxation 725.

³⁹ W. Braun Co., Inc., § 67.066 P-H Memo T.C. (1967-66).

an unsuccessful agency in 1960, and due to his efforts had built up a very successful business.⁴⁰ In another part-time salary case the court allowed a \$21,000.00 salary, due mainly to the fact that there had been underpayment in earlier years.⁴¹ The fourth recent case brings out the fact that one can be paid royalties for a patent, above and beyond the normal salary. In this case the president of the corporation was deemed to give his greatest value to the corporation as an inventor.⁴²

The entire question of reasonable salaries appears to be divided between two sides. The first is that of the Internal Revenue Service, which appears to be very conservative in allowing salaries. The courts have taken the more liberal view, and what seems to be the better position. The Internal Revenue Service appears to look only at the dollar figure and does not take into account the overriding circumstances. The courts, on the other hand, have very few rigid rules and attempt to justify each case on its own merits. In this area, rigid rules would be totally impossible; and what we lose in predictability we more than gain in a fair assessment of each individual case. It would seem that the Internal Revenue Service should review their position in light of the court decisions for a more equitable result. It is usually the larger corporation which can afford the expense of litigation through the Federal Court System, whereas most closely held, small corporations "settle" with the Internal Revenue Service without further expense. Of course, the laws of our country, even tax laws, were not intended to be "settled" on the basis of an inability to afford the cost of litigation. The laws should be equal for all, and the Internal Revenue Service should attempt to turn its position toward the direction of the equitable court view, rather than retain a coldly grasping tax collector's viewpoint.

Conclusion

The problem now is how to bring the law up to a point where the average officer, in a closely held corporation, can obtain a liberal attitude from the Internal Revenue Service without resorting to the Federal Court System. If we assume that the Internal Revenue Service is the enforcer of the legislatures' laws, then we must begin with the legislature. The answer must lie in a tax law that can give a man guidelines to follow before the salary is paid. The laws must be flexible enough to meet different situations, and yet not so vague as to leave it up to the Internal Revenue Service's interpretation. Once this hurdle is cleared, we must have a co-ordinated effort between Congress, the Federal Court System and the Internal Revenue Service in answering the question of what is a reasonable salary.

⁴⁰ Van's Chevrolet, Inc., § 67.172 P-H Memo T.C. (1967).

⁴¹ Weise-Winckler Bindery, Inc., § 67.259 P-H Memo T.C. (1967).

⁴² Appleton Electric Company, § 67.211 P-H Memo T.C. (1967).

Above all, it is our duty as lawyers to clarify the law so that the taxpayer will receive the most benefit within the framework of an equitable tax structure. The attorney must lead the way, because only he has the knowledge and influence to tackle the immense tax problem that now affects so many people.