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KEY SERVICE INSIGHTS

BUSINESS TAX NEWSLETTER

AVOIDING DIVIDEND RECLASSIFICATION: KEY TAX TAKEAWAYS FOR CLOSELY HELD C-CORPORATIONS

CLARY HOOD, INC. V. COMMISSIONER, 69 F.4TH 168 (4TH CIRCUIT)

Case Overview

Issue

Could the privately held corporation (C-corporation) deduct bonuses paid to the CEO/shareholder for undercompensating the CEO for prior years?

Held

No, the corporation can only deduct reasonable compensation each year for the past years of undercompensation based on a multi-factor test.

Key Insight

This case highlights the need for C corporations to have a dividend policy and history. It also highlights the need to carefully consider the compensation paid each year to the shareholder-employee of a closely held corporation to have better support of reasonable compensation in order to avoid the recharacterization of deductible compensation to nondeductible dividend distributions. It would likely have been tax advantageous for the Taxpayer to be an S corporation.

Brief Overview

The Taxpayer was a subchapter C corporation. The CEO and his wife were the only shareholders and board of directors of the Taxpayer. The Taxpayer operated a land excavation and grading business and averaged gross revenue of $21 million from 2000–2010, which grew to $44 million in 2015 and $69 million in 2016.

The Taxpayer never paid any dividends. The CEO's annual salary ranged between $130,000 to $196,500. In part to make up for undercompensating the CEO in prior years, the Taxpayer paid the CEO bonuses of $5 million in each of 2015 and 2016.

The Taxpayer, in consultation with its accountants, determined that the $5 million bonuses paid to the CEO in each of the years 2015 and 2016 were appropriate to reflect the Taxpayer's recent success and to remedy undercompensating the CEO in prior years. On audit, the IRS challenged the Taxpayer's bonuses to the CEO as unreasonable and therefore nondeductible to the extent of $1.3 million for 2015 and $3.6 million for 2016.

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Legal Analysis

The Court recited the applicable law of IRC § 162(a)(1) limiting a taxpayer's deduction for salaries and other compensation to a "reasonable allowance … for personal services actually rendered." The Court then highlighted the directive of Treasury Regulations § 1.162-7(b) that reasonable compensation is determined by taking into account "all the circumstances." The Court further determined that compensation paid by closely held corporations is subject to "close scrutiny" because such payments may be disguised dividends.

The Court found that the reasonableness of compensation is determined based upon a multi-factor analysis which considers the "totality of the circumstances," including:

- the employee's qualifications;
- the nature, extent and scope of the employee's work;
- the size and complexities of the business;
- a comparison of salaries paid with gross income and net income;
- the prevailing general economic conditions;
- comparison of salaries with distributions to stockholders;
- the prevailing rates of compensation for comparable positions in comparable concerns;
- the salary policy of the taxpayer to all employees.

Conclusion

This case highlights the need for C corporations to have a dividend policy and history. It also highlights the need to carefully consider the compensation paid to the shareholder employees of a closely held corporation to avoid recharacterization. It would likely have been tax advantageous for the Taxpayer to be an S corporation.

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