

# Disguised Dividends and Shareholder/ Employee Compensation

Eliza Jones and Lisa H. Tran

*The reasonableness of shareholder/employee compensation in a closely held corporation is an important and often controversial issue. The Internal Revenue Service sometimes alleges that shareholder dividend payments are disguised as a management fee, executive bonus, or “catch-up” payment. In whatever form the shareholder/employee compensation is reported, closely held company owners often rely on analysts to help them determine a reasonable level of executive compensation in order to respond to Internal Revenue Service challenges. This discussion (1) reviews statutory authority and judicial precedent regarding reasonable compensation for shareholder/employees and (2) summarizes some of the shareholder/employee compensation issues from recent judicial decisions.*

## INTRODUCTION

Internal Revenue Code Section 162(a) allows expenses incurred or paid by a business in a taxable year to be deducted for U.S. federal income tax purposes. Such income tax deduction may include reasonable compensation for services rendered.

If the business is a closely held corporation and the persons receiving the compensation are shareholders, the payments (which may include a salary, bonus, or other compensation paid to shareholder/employees) may be subject to close scrutiny by the Internal Revenue Service (the “Service”).

The Service may want to determine if the income tax deduction represents:

1. market-based compensation for the services actually rendered or
2. a disguised distribution of company profits to shareholders.

There can be significant tax-related consequences (e.g., a tax understatement penalty associated with the deduction of an unreasonable amount

of shareholder/employee compensation) associated with unreasonable shareholder/employee compensation tax deductions.

In some cases where the shareholder(s) owns several related businesses, the compensation may be presented in the form of a management fee that one entity charges to another related entity for consulting services provided by the shareholder/employee(s).

This form of compensation issue arose in the matter of *Aspro, Inc. v. Commissioner*.<sup>1</sup> In this decision, the U.S. Tax Court supported the Service’s position and disallowed all deductions for management fees comprised of compensation paid to all three shareholder/employees of the private corporation over a three-year period.

Executive compensation in the form of a “catch-up” payment may also be scrutinized by the Service as a nondeductible dividend. This form of compensation issue arose in the matter of *Clary Hood, Inc. v. Commissioner*.<sup>2</sup>

In this decision, the Tax Court reduced the executive compensation that the taxpayer

corporation could claim as a business expense over a two-year period.

## REASONABLE COMPENSATION GUIDANCE

Compensation paid to shareholder/employees is often scrutinized by the Service. Shareholder/employees of closely held C corporations may have an incentive to pay themselves higher salaries in order for the private corporation to avoid paying federal income taxes on its operating profit.

In addition, the Service often claims that excess compensation represents a disguised—and nondeductible—dividend to the shareholder/employees.

Section 162(a) provides that executive compensation is deductible as a business expense if it is:

1. reasonable in amount and
2. based on services actually rendered.<sup>3</sup>

For shareholder/employee compensation to qualify as employee compensation, Treasury Regulation 1.162-7 lists the following four requirements. Shareholder/employee compensation should be:

1. an ordinary and necessary expense,
2. reasonable in amount,
3. based on services actually rendered, and
4. actually paid or incurred by the taxpayer corporation.<sup>4</sup>

According to Regulation 1.162-7, a taxpayer corporation may deduct a shareholder/employee compensation payment that is based on performance using a percentage formula.

Shareholder/employee compensation based on a percentage formula may be:

1. a percent of corporation revenue,
2. a percent of corporation earnings, or
3. a percent of some corporation income measure.

In addition to the Treasury Regulations on the reasonableness of shareholder/employee compensation, taxpayer companies also can review the judicial precedent that considers the reasonableness of executive compensation.

Factors to consider in determining the reasonableness of shareholder/employee compensation were presented by the Court of Appeals years ago in the *Mayson Manufacturing Company v. Commissioner* decision.<sup>5</sup>

The *Mayson* decision listed eight factors that may be evaluated in determining the reasonableness of compensation paid to a shareholder/employee.

In the 1996 *Pulsar Components International, Inc. v. Commissioner* decision,<sup>6</sup> the Tax Court expanded the *Mayson* factors to include the following:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's work
3. The size and complexities of the employer's business
4. A comparison of salaries paid with the employer's gross and net income
5. The prevailing general economic conditions and the background of the industry
6. A comparison of salaries with distributions to officers and retained earnings and the employer's dividend history
7. The prevailing rates of compensation for comparable positions in comparable concerns
8. The salary policy of the employer as to all employees
9. The amount of compensation paid to the particular employee in previous years
10. The employer's financial condition
11. Whether the employer and employee dealt at arm's length
12. Whether the employee guaranteed the employer's debt
13. Whether the employer offered a pension plan or profit sharing plan to its employees
14. Whether the employee was reimbursed by the employer for business expenses that the employee paid personally

In the *Trucks, Inc. v. U.S.* decision,<sup>7</sup> the District Court considered the following factors in its assessment of the reasonableness of shareholder/employee compensation for a closely held C corporation:

1. Training and qualifications
2. Responsibilities and number of hours worked
3. Results of employee's efforts
4. Ratio of compensation to company growth (before salaries and tax)
5. Absence of fringe benefits available to executives in comparable companies

6. Responsibility for inception and/or success
7. Correlation between compensation and ownership interest

Additionally, the federal courts have increasingly applied the independent investor test in shareholder/employee reasonable compensation disputes. The Tax Court first applied what is called the independent investor test in 1984 in the *Elliotts, Inc. v. Commissioner*<sup>8</sup> decision.

In the independent investor test, the Tax Court considered whether an independent investor would pay the shareholder/employee the same compensation he or she was receiving from the company.

The Tax Court based its independent investor consideration on (1) the actual rate of return on owners' equity for the subject company compared to (2) a market-derived required rate of return on owners' equity.

The following discussion summarizes recent judicial decisions related to the determination of the reasonableness of shareholder/employee compensation paid by closely held corporations.

## COMPENSATION FROM RELATED ENTITIES

### Aspro, Inc.

In *Aspro, Inc. v. Commissioner*, the Tax Court considered the issue of shareholder/employee compensation deducted as management fees.

For the tax years 2012 to 2014, Aspro, Inc. ("Aspro"), paid management fees to its three shareholders:

1. Milton Dakovich (owning 20 percent of the Aspro stock)
2. Jackson Enterprises Corp. (owning 40 percent of the Aspro stock)
3. Manatt's Enterprises, Ltd. (owning 40 percent of the Aspro stock)

A C corporation, Aspro operated an asphalt paving business with two asphalt plants located in Waterloo, Iowa, and it employed 66 to 75 employees. Aspro generated revenue mainly from government contracts.

Milton Dakovich ("Dakovich") served as Aspro's president. His job responsibilities included project oversight, identifying and bidding on projects, and making equipment and personnel decisions.

Dakovich's compensation for his services at Aspro included a base salary, a bonus, management fees, and director fees. The Aspro board of directors set the amount of the management fees.

An S corporation, Jackson Enterprises Corp. ("JEC") was a holding company with no operations or employees. Stephen Jackson ("Jackson") served as its president.

JEC owned 98 percent of Cedar Valley Corp. ("CVC"), which provided concrete paving services in Iowa, Missouri, and Nebraska. Owned by Jeff Rost ("Rost"), Cedar Valley Management Corp. provided management services to CVC, and it employed Jackson, Rost, Virginia Robinson, William Calderwood, and Michael Cornelius.

According to testimony for the taxpayer (i.e., Aspro), these individuals provided services (e.g., advice on contract bids and equipment purchases) to Aspro and Dakovich at one time or another during the years in question.

A C corporation, Manatt's Enterprises, Ltd. ("ME"), operated a farming operation in Iowa. ME did not provide asphalt or road paving services. Tim Manatt ("Manatt") served as ME's president. Manatt was not an officer of Aspro and did not enter into any written consulting or management services agreement with Aspro. At times, Manatt would advise Dakovich on certain business matters.

Exhibit 1 presents (1) the management fees paid to the three shareholders and (2) the Aspro reported revenue and net income for the years in question.

In testing whether shareholder/employee compensation can be deductible as a business expense and to ensure that the payments are not disguised distributions, the Tax Court considered if the compensation represented payments purely for services rendered.

In this case, the Tax Court found the following:

1. Aspro made no distributions to its three shareholders but paid management fees each year.

In fact, the Tax Court found no evidence that Aspro ever made distributions to its three shareholders during its entire corporate history.

2. The two largest shareholders (i.e., JEC and ME) received equal payments in management fees, and the percentages of the management fees corresponded approximately to the respective ownership interest in Aspro by each shareholder.

This supports the inference that the management fees paid actually represented distributions.

3. Aspro paid management fees as lump sums at the end of the tax year rather than throughout the year as the services were performed.
4. Aspro paid management fees to JEC and ME, instead of the actual entities or individuals performing the services.
5. Aspro reported negligible taxable income after the payment of the management fees. Sometimes, a court gauges if a corporation is disguising the distribution of dividends as compensation by considering the compensation a percentage of taxable income before deducting the compensation in question.

The management fees paid in 2012, 2013, and 2014 reduced Aspro's taxable income by 89 percent, 86 percent, and 77 percent, respectively.

6. The Tax Court could not find any written management or consulting services agreements between Aspro and any of its three shareholders. No management fee rate or billing structure was negotiated or agreed to by the shareholders and Aspro.

Further, Aspro did not receive any invoices for any services provided by the shareholders.

7. The management fees were determined by the Aspro board of directors near the end of the tax year when the board had a better idea of the company's financial performance for the year.

The board minutes did not indicate how the management fee amounts were determined.

8. Aspro provided no evidence to demonstrate what companies comparable to Aspro would pay for such services provided by the three shareholders.

Reasonable compensation is only the amount that would ordinarily be paid for like services by like enterprises under like circumstances.<sup>9</sup>

In assessing whether the management fee paid to Dakovich was reasonable, the Tax Court relied on

## Exhibit 1

*Aspro, Inc. v. Commissioner*

### Management Fees and Reported Company Financials

Tax Years	Aspro Revenue (\$000)	Aspro Net Income (\$000)	Mgmt. Fees Paid to Dakovich	Mgmt. Fees Paid to JEC	Mgmt. Fees Paid to ME
2014	23,587.0	1,103.1	\$200,000	\$800,000	\$800,000
2013	22,478.5	-131.7	\$150,000	\$800,000	\$800,000
2012	25,926.4	192.6	\$166,000	\$500,000	\$500,000

the Service's expert witness, Ken Nunes ("Nunes"), a chartered financial analyst and business valuation analyst.

Nunes relied on compensation data from the 2012 *Executive Compensation Survey of Contractors* published by PAS, Inc., for companies operating in the construction industry similar in size and location of operations to Aspro.

The Nunes expert report concluded that Dakovich was overcompensated relative to other chief executive officers ("CEOs") employed in the relevant industry.

In addition, Nunes provided data and analysis that indicated that the Aspro compensation structure did not allow for adequate shareholder returns. After payment of the management fees, Aspro's operating margins were well below those of its industry peers.

Aspro failed to present evidence or expert testimony showing that an independent investor would receive a reasonable return on an investment in Aspro with the existing shareholder compensation structure.

Since Aspro was unable to provide documentation supporting the nature of the management fees and did not retain an analyst to argue for the reasonableness of the compensation paid to Dakovich, this case was an easy victory for the Service.

The Tax Court supported the Service's position to disallow all the reported management fees, thereby causing Aspro to owe income tax deficiencies for the years in question.

## COMPENSATION THAT INCLUDES CATCH-UP PAY

### Clary Hood, Inc.

In *Clary Hood, Inc. v. Commissioner*, the Service determined that for tax years 2015 and 2016, the

amount of compensation paid to CEO Clary Hood (“Hood”) exceeded reasonable compensation.

In this case, the Tax Court applied a multifactor assessment to determine the reasonableness of shareholder employee compensation based on the precedent of the U.S. Court of Appeals for the Fourth Circuit.

If appealed, this case would go to the Court of Appeals for the Fourth Circuit. At the date of this trial, the Court of Appeals had not adopted any application of the independent investor test.

In 1980, Hood and his wife founded Clary Hood, Inc. (“CHI”), a C corporation providing land grading and excavation services for construction projects in the South Carolina region. Hood and his wife were the CHI sole shareholders and members of the board of directors.

The company expanded from only 2 employees to 150 employees and generated nearly \$70 million in revenue by the 2016 tax year.

From 2000 to 2010, CHI experienced modest growth, achieving less than \$1 million in net income in most years. During the great recession (from 2009 to 2011), the company survived due to Hood’s decisions to:

1. conserve cash;
2. temporarily reduce employee pay;
3. withhold Hood’s salary, when necessary; and
4. sell equipment to generate cash.

In 2012, Hood made the unilateral decision to transition away from providing site grading work for

Walmart, Inc; this was one of the CHI’s most significant and consistent sources of revenue.

Though producing lower operating margins due to bidding and pricing pressures, these Walmart projects generally accounted for more than 20 percent of company revenue between 1999 and 2011.

Beginning in July 2011, CHI began diversifying its customer base by transitioning from retail-related projects to the commercial and industrial market sectors.

Fortunately, CHI won the bid for a sizable project in North Carolina that generated over \$30 million in revenue and became the most significant and profitable project for the company.

Through Hood’s efforts, CHI won two additional significant projects through 2014. Accordingly, the CHI revenue increased from \$20.6 million in 2010 to \$68.8 million in 2016.

While Hood held various job titles at CHI, his responsibilities at the company did not change much. These responsibilities included the following:

1. Equipment oversight
2. Hiring, training, and supervision of mechanics
3. Supervision and inspection of job sites
4. Preparation and review of job bids
5. Negotiation of job bids
6. Setting employee compensation
7. Acquisition of bonding

In addition to his job responsibilities at CHI, Hood and his wife would personally guarantee any claims the bonding companies had against CHI and guaranteed payment of some of the company’s loans, credit lines, and capital leases.

Hood’s compensation was not set by any employment contract or agreement, and sometimes varied based on the financial well-being of the company.

The CHI board of directors set the amount of Hood’s annual compensation, including bonuses.

In 2014, the CHI chief financial officer, Chris Phillips (“Phillips”) believed that Hood was undercompensated in prior years and sought advice on Hood’s future compensation structure.



Using compensation data from PAS, Inc., and a 2010 Construction Financial Managers Association survey, Hood, Phillips, and CHI's outside accountant agreed that Hood should receive \$5 million in bonuses going forward for services provided in previous years.

Exhibit 2 presents the CHI reported revenue and earnings before taxes, and compensation for Hood as CEO.

The total compensation that was determined for Hood included a base salary, an annual bonus, an annual fee for bonding guarantees, and an annual debt guaranty fee.

## Multifactor Approach

The Tax Court accepted that Hood was a significant contributing factor to the CHI financial success for the years in question and that Hood was also entitled to some degree of additional compensation for prior services rendered. However, the Tax Court questioned what level of executive compensation was reasonable as a deduction for a business expense.

In following the guidance of the U.S. Court of Appeals for the Fourth Circuit, the Tax Court considered multiple factors in determining the amount of reasonable compensation for Hood, including Hood's background and qualifications.

Hood had over 50 years of relevant work experience in land grading and excavation and established an excellent reputation for CHI in the market.

The Tax Court considered Hood's job responsibilities and the total hours he worked at CHI. Hood was the driving force behind the company's success and typically worked 60–70 hours per week, including weekends.

The Tax Court considered the size and complexity of the CHI business. CHI specialized in land grading and excavation, which is more complex than providing general construction services. Through Hood's expertise and contribution, CHI became an important player in a niche market.

The Tax Court considered whether prevailing economic conditions or Hood's efforts contributed to the success of the company.

The CHI outside accountant testified that CHI was his most profitable client between 2013 and

## Exhibit 2 Clary Hood, Inc. v. Commissioner Compensation and Reported Company Financials

Tax Years	Clary Hood Revenue (\$Mil.)	Clary Hood EBT (\$Mil.)	CEO Base Salary (\$)	CEO Bonus (\$)	Total CEO Compensation (\$)
2016	68.8	14.5	196,500	5,000,000	5,196,500
2015	44.1	7.1	168,559	5,000,000	5,168,559
2014	34.1	8.3	181,538	1,500,000	1,681,538
2013	42.8	7.4	381,707	1,000,000	1,381,707
2012	23.7	2.3	21,100	200,000	221,100
2011	15.6	loss	83,400	35,000	118,400
2010	20.6	loss	132,500	0	132,500
2009	27.8	loss	130,000	0	130,000
2008	38.4	2.9	130,000	320,981	450,981

2016 due to Hood's contributions, which ensured the survival of the company through the great recession.

The Tax Court considered Hood's compensation with distributions to stockholders. CHI reported a significant increase in profitability from 2013 to 2016, yet never declared or paid *any* cash dividends.

Hood was a controlling shareholder of CHI. Yet, CHI elected to reward Hood for his efforts with a significant cash bonus rather than through a dividend payment.

The Tax Court considered the CHI compensation policy for all its employees. CHI had no structured system for establishing the compensation of its nonshareholder employees. Hood personally determined the compensation of the CHI executives based on his subjective beliefs.

Hood's total compensation in 2015 and 2016 represented almost 90 percent of the total compensation of the other CHI executives who worked nearly the same number of hours as Hood.

Finally, the Tax Court considered prevailing market-based executive compensation for comparable positions in companies comparable to CHI. For this, the Court found the Service's expert witness, David Fuller ("Fuller"), founder of Value, Inc., a financial and valuation consulting firm, to be credible.

The Fuller report provided data and analysis regarding what companies similar to CHI would pay in compensation for Hood's services. The Fuller

report relied upon the Risk Management Association data for executive compensation for the site preparation contractors industry, and compensation data provided by PAS, Inc., for the construction industry.

The Fuller report concluded that the amount of reasonable compensation for Hood should be \$3,681,269 in 2015 and \$1,362,831 in 2016.

The Tax Court assigned little or no weight to the testimonies of the CHI expert witnesses, Samuel Kursh of BLDS, LLC (“BLDS”), and Theodore Sharp, a senior partner at Korn Ferry.

The Tax Court found both experts’ reports lacking in support for its calculations and conclusions and in the disclosure of data sources relied upon.

The BLDS report compared CHI, a private regional specialty construction firm, to significantly larger-size public companies with diversified operations. The Korn Ferry report relied on compensation survey data for companies with up to \$500 million in annual revenue.

While the Tax Court agreed that Hood should be compensated appropriately for his contributions to the success of CHI, including back pay for services rendered in prior years, the Tax Court concluded that CHI failed to establish that the amounts deducted as compensation in 2015 and 2016 were reasonable.

Relying on the Fuller report, the Tax Court concluded that the amount of reasonable compensation for Hood should be \$3,681,269 in 2015 and \$1,362,831 in 2016.

## SUMMARY AND CONCLUSION

The reasonableness of shareholder/employee compensation in a closely held corporation is an important and often controversial issue. Compensation that is considered reasonable by the corporate taxpayer may be considered unreasonable by the Service.

This is because a shareholder /employee may be motivated to deviate from arm’s-length compensation in order to minimize the income tax deduction attributable to the closely held corporation.

The Service may allege that excess shareholder/employee compensation:

1. absorbs taxable corporate income and
2. represents a disguised nondeductible dividend to the shareholder.

The Service may allege that excess shareholder/employee compensation may be disguised as a management fee or as back pay.

The tax consequences associated with unreasonable shareholder/employee compensation may be significant. The taxpayer corporation bears the burden of proof that the reasonable compensation determination by the Service is incorrect.

Determining the reasonableness of shareholder/employee compensation can be a challenging task. Over the years, the Service and the courts have developed numerous guidelines to enable corporate taxpayers and their consultants to determine the reasonableness of shareholder/employee compensation.

In whatever form the shareholder/employee pay is reported, closely held companies may rely on analysts to help them determine a reasonable level of executive compensation in order to minimize the risk of challenge from the Service.

In *Aspro, Inc. v. Commissioner*, the corporate taxpayer did not employ an analyst to determine reasonable compensation. In *Clary Hood, Inc. v. Commissioner*, the corporate taxpayer employed two analysts who produced expert reports and compensation conclusions that the Tax Court considered to be unreliable. In both cases, the Service prevailed on its claims.

### Notes:

1. *Aspro, Inc. v. Commissioner*, T.C. Memo. 2021-8 (Jan. 21, 2021).
2. *Clary Hood, Inc. v. Commissioner*, T.C. Memo. 2022-15 (Mar. 2, 2022).
3. Internal Revenue Code Section 162(a)(1).
4. Treasury Regulation 1.162-7.
5. *Mayson Manufacturing Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949).
6. *Pulsar Components International, Inc. v. Commissioner*, T.C. Memo. 1996-129 (Mar. 14, 1996).
7. *Trucks, Inc. v. U.S.*, 588 F. Supp. 638 (D.C. Neb. 1984).
8. *Elliotts, Inc. v. Commissioner*, T.C. Memo. 1984-516 (Sept. 27, 1984).
9. Sec. 1.162-7(b)(3), Income Tax Regs.

*Eliza Jones is an associate located in our Portland, Oregon, practice office. Eliza can be reached at (503) 382-4089 or at elizabeth.jones@willamette.com.*

*Lisa Tran is a vice president also located in our Portland, Oregon, practice office. Lisa can be reached at (503) 243-7510 or at ltran@willamette.com.*

