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Take Care in the "Zero Out" of Income Generated by Incorporated Professional Practices

Several Lessons Can Be Learned from Recent Case

A recent Tax Court case reminds physician and other incorporated medical practice groups to take care in the "zero out" approach to the payment of compensation to the group's owners. Under this technique, a practice group organized under local law as a professional corporation (PC) or a professional association (PA) and that is taxed as a "C" corporation for federal tax purposes compensates its physician or other licensed professional shareholders periodically during the year by payment of a base compensation that constitutes a predetermined percentage of budgeted annual operating profits. Once actual year-end operating results are determined (or reasonably estimated), prior to its taxable year–end, the PC or PA pays a bonus to the practice group shareholders based on its distributable cash using the formula adopted by the practice group members to pay annual compensation to and among its professionals. These bonuses "take into account" the amounts previously paid to each professional as base compensation during the year. Through the payment of year-end bonuses, the taxable income of the PC or PA is reduced to zero or a nominal amount. Because the bonuses are deducted by the PC or PA as a compensation expense, the PC or PA typically pays little or no federal income tax.

In *Brinks Gilson & Lione PC,* TC Memo 2016-20, the Tax Court upheld the imposition of accuracy-related penalties against an incorporated law firm that improperly treated all of its year-end bonuses for several tax years as deductible compensation. In support of its finding, the Tax Court concluded that the law firm did not have substantial authority to deduct the mischaracterized compensation payments that should have been treated as nondeductible dividends, thus increasing the law firm PC's taxable income for each tax year to which the case applied. Because the law firm and the Internal Revenue

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Service (IRS) had previously agreed as to what portion of the bonuses for each year were nondeductible in resolution of an audit of the firm, the Tax Court did not address the deductibility of the payments that the law firm and the IRS had agreed were mischaracterized. It only addressed whether an accuracy-related penalty should be imposed on the PC based on its improper deduction of the mischaracterized payments as deductible compensation. Even so, several lessons can be learned from the *Brinks* case.

Lesson 1

Do not reallocate shares of stock in a PC or PA among the practice group owners as annual or other periodic adjustments take place that reallocate compensation among the group owners.

In the *Brinks* case, the PC adjusted the share ownership of its attorney shareholders on an annual basis based on adjustments to annual compensation payable to its attorney-stockholders for the ensuing year. As a result of this practice, the taxpayer PC's share ownership always matched the compensation payable to its attorney shareholders.

The Tax Court pointed out that this practice of readjusting share ownership was a factor in upholding the accuracy-related penalties. As a result of this cautionary note, a better approach for an incorporated practice group is to issue shares to its shareholders in a fixed amount determined at the time a group member becomes a shareholder and not to adjust the shares issued to each shareholder each year or otherwise. Even under this recommended approach, the equity ownership in the PC or PA can still adjust as new professionals join the practice group (to whom additional shares are issued) or existing shareholders leave the practice, retire, or die (which would result in share redemptions). The PC or PA can still pay compensation to its practice group members irrespective of relative share ownership based on the practice's compensation formula as that changes from time-to-time.

Lesson 2

Declare a dividend that provides a reasonable return on invested capital.

In the *Brinks* case, to resolve the audit that preceded the law firm's filing of the Tax Court case, the taxpayer law firm had agreed with the IRS that the year-end bonuses paid as compensation to its officers should have been treated as nondeductible. This resolution of the audit did not recharacterize as dividends all of the year-end bonuses paid during the tax years in question. The agreed upon amounts recharacterized as dividends resulted in on average an 11 percent to 12 percent "return on invested capital" to the shareholders of the PC during the audit years. For example, in the 2007 tax year, the PC paid a total of $9M in bonuses to its attorney shareholders, but the audit resulted in $1.1M of those bonuses (the amounts paid as officer compensation for that year) being treated as nondeductible dividends. Since the taxpayer PC had $8M in invested capital in that year, its owners received an annual dividend of just under 14 percent on the invested capital of its attorney-shareholders.[1]

Lesson 3

Enter into employment agreements that contain objective compensation formulae.

Although the *Brinks* case did not indicate whether the attorneys who were shareholders in the law firm had entered into employment agreements with the PC, if so, this contractual commitment would have helped. In such a case, the law firm could have objected to any recharacterization of contractually required payments for services rendered by its shareholders since the firm would have been in breach of its employment agreements if it had failed to pay the amounts required under the agreements with its shareholder-employees.

Endnote:

1. The decision in the Tax Court case ignores the fact that dividends should be paid proportionally to all shareholders rather than only to one or more groups of shareholders (*i.e.*, only to the firm's management team members as "officers' compensation").

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