Caution As To Compensation Paid By Professional Corporations

By RALPH LEVY

Two recent Tax Court cases raise caution flags as to the deductibility of shareholder compensation by medical, dental and other professional practice groups organized as professional corporations (PCs) or professional associations (PAs) that are taxed as "C" corporations for federal tax purposes. In each case, on audit, the IRS sought to disallow deductions for a portion of the compensation paid to the corporation's shareholders and asserted that the payments should be treated by the payor "C" corporation as nondeductible dividends.

In *Brinks Gilson & Lione, P.C. v. Comm'r,* T.C. Memo 2016-20, the Tax Court upheld accuracy-related penalties against an incorporated law firm taxed as a "C" corporation that had deducted all of its year-end bonuses paid to its attorney shareholders. As part of resolution of an audit prior to the initiation of the Tax Court case, the law firm had agreed that a portion of the bonuses were not deductible. However, the audit resolution did not address whether accuracy-related penalties should be assessed against the law firm.

The Tax Court found that the law firm did not have substantial authority to deduct that portion of its year-end bonuses that it had agreed on audit were not deductible. The Tax Court relied on several factors in support of its decision. For example, the law firm reallocated its shares annually based on annual adjustments to compensation paid to its shareholders so that its proportionate share ownership always matched relative compensation payable to its attorney shareholders. In addition, the firm did not pay any dividends to its shareholders on their significant invested capital in the firm.

The second case, *H. W. Johnson,* Inc. v. Comm'r, T.C. Memo 2016-95, upheld deductions by a concrete contracting corporation for compensation paid to two individuals who were brothers. During the tax years in question, the two brothers received base compensation set annually in advance at a meeting of the Board of Directors of the corporation. During the same meeting, the Board of Directors approved the objective criteria for annual bonuses to the two brothers and other management employees if that year's profits exceeded certain specified amounts. In addition, each year the corporation paid a nominal dividend as to the shares owned by its shareholders (which included the two brothers and another family member who did not perform services for the corporation).

In support for its conclusion to uphold the deductibility of the compensation paid to the two brothers (i.e., that the compensation was reasonable in amount), the Tax Court applied five different factors with significant focus on the key roles that the two brothers played to the success and significant financial growth of the corporation during the tax years under review. As part of this analysis, the Tax Court pointed out that even though the brothers' family (i.e., the two brothers and their mother) owned all stock in the corporation and thus would approve payment of otherwise nondeductible corporate distributions as compensation (referred to by the Tax Court as "[a] potentially exploitable relationship"), the corporation generated slightly in excess of 10 percent annual pre-tax return on the corporation's equity, which exceeds the minimum threshold return that would be insisted upon by an independent investor in a corporation of this type. Finally, the Tax Court cited with favor in a footnote the annual dividend paid to the corporation's shareholders each year.

Medical, dental and other professional practice groups organized as entities (PA's or PC's) that are taxed as "C" corporations can derive several lessons from these two Tax Court cases.

Lesson #1: Do not reallocate shares in the PC or PA annually based on periodic compensation adjustments among the practice group owners. In *Brinks,* the Tax Court noted with disfavor the law firm's annual readjustment of share ownership to match compensation payable that year to its attorney shareholders.

Lesson #2: Declare an annual dividend that provides a reasonable return on invested capital. In the law firm did not pay any dividends; by contrast, in *Johnson*, the corporation paid a dividend each year.

Lesson #3: Establish in advance on at least an annual basis the compensation amounts payable to all shareholders who perform services for the corporation both as to base compensation and incentive compensation amounts (with the latter component of compensation preferably determined in large part by objective formulas such as revenues exceeding certain thresholds). Ideally, memorialize the compensation arrangements in long term employment agreements with the practice group's professional shareholders.

The lessons learned from these two cases can go a long way to help the practice group defend the deductibility of compensation paid to its practice group shareholders.

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