Oops: When Management Fees to Related Entities Aren't Deductible

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Here at the M&A TAX REPORT, we know readers need developments in acquisition techniques and taxes. This is so whether you're facing a big acquisition of the once-in-a-lifetime variety, or a small, plain-vanilla deal. Sometimes, though, it's the most basic things that can trip you up.

Remember "My Kingdom for a Horse?" This immortal phrase was cried in exasperation by the King in Shakespeare's RICHARD III. It paints a graphic picture of the universal truth that we all need simple things, and, perhaps more strikingly, that sometimes something quite small can spell the difference between success and failure. Although it doesn't have the same literary ring, remember too that the straw broke the camel's back. This phrase traces its etymology to an Arab proverb. More modern popular usage is often attributed to Charles Dickens.

Today, our story begins with a pedestrian topic that is nevertheless important: payments between related entities. There is nothing untoward about one party paying a related entity for goods and services. The key question is the reason for the payment along with the intertwined question of how reasonable the payment may seem. Inevitably, these are judged against outside third-party standards. This is hardly sophisticated.

Poor Relations

Recently, I wrote about a *tour de force* of related party payments. [*See* Wood, *Why Deductions for Related-Party Payments Are Scrutinized*, M&A TAX REP., May 2011, at 4.] The subject of that mess was *Mulcahy, Pauritsch, Salvador & Co., Ltd.*, 101 TCM 1340, Dec. 58,586(M), TC Memo. 2011-74. There, the Tax Court considered an accounting firm that had claimed deductions for consulting payments to related entities. The monies were subsequently passed along to the founders of the firm. This is a fun case to read, though not one in which you would want to imagine yourself as the taxpayer.

Mulcahy, Pauritsch, Salvador & Co. is not your normal case in which the nature, quantity and value of the services were front and center. This case had the unusual wrinkle of the related entity end-run (or perhaps I should say *attempted* end-run). These accountants were hardly wizards of Internal Revenue Code Section ("Code Sec.") 482 or even Code Sec. 162.

Indeed, their erstwhile clever shell game moving millions of dollars from one company to the next turned out not to be so clever after all. But in the world of the closely held company, the hits just keep on coming. Axiomatically, fees paid to related parties must be for something.

That was one fundamental lesson of—and I love this name—*Weekend Warriors Trailers, Inc., et al.*, 101 TCM 1506, Dec. 58,626(M), TC Memo. 2011-105. In this case, the Tax Court ruled that fees paid from a C corporation trailer manufacturer to a commonly controlled S corporation weren't deductible business expenses. At least there was a management agreement between the entities.

Plainly, though, that wasn't enough. With closely held corporations, machinations with and involving related entities are quite common. C corporations may be paired with S corporations or LLCs taxed as partnerships. There are often payments made between such entities, and the tax impact of the payments is inevitably a big issue.

Weekend Warrior?

No, I didn't make up the weekend warrior name. A lifelong off-road vehicle enthusiast, Mark Warmoth worked for a major RV manufacturer for many years. Then in 1988, he started his own RV business, manufacturing a unique travel trailer designed to transport off-road vehicles to the desert. He incorporated Weekend Warrior Trailers in 1995 and elected S status in 2003.

In 2002, Warmoth hired a financial planner to prepare an overall plan and to advise him on how to handle the company's rapid growth. Along with a veritable team of advisors (another questionable sign of financial success), the financial planner recommended creating an S corporation to be called "Leading Edge." The S corporation thereafter sprang into existence. On Dec. 28, 2002, Weekend Warrior and Leading Edge entered into a management agreement.

Soup to Nuts?

This management agreement called for Leading Edge to provide design, personnel and management services to Weekend Warrior. The personnel were provided by transferring employees of Weekend Warrior to Leading Edge and then leasing them back. In all, Weekend Warrior paid over $4 million in management fees in 2002 and 2003. Weekend Warrior paid an additional $2 million to Leading Edge in 2004.

Leading Edge paid a portion of Warmoth's wages as well as the wages of his top managers. Leading Edge also made several loans to Weekend Warrior. Warmoth initially received 10,000 shares of Leading Edge stock, for which he was to pay $20,000. In fact, though, Warmoth never paid for his stock. In any case, he was Leading Edge's only director until early 2003.

Leading Edge was inactive by December 31, 2004. Weekend Warrior itself ceased operations in July of 2008. From 2002 through 2004, however, Weekend Warrior claimed deductions for management fees of over $4 million annually. It also claimed employee leasing fees in 2003 and 2004 of $13 million and $14 million, respectively.

The employee leasing fees were not challenged by the IRS. The management fees, however, were another matter. Leading Edge included the management and employee leasing fees in income for 2002 through 2004. It reported small amounts of "other" income in 2003 and 2004, along with $176,495 of investment income in 2004.

Weekend Warrior reported shareholder loans on its Schedule L's for 2002 through 2004 of approximately $1.2 million, $2 million and $3.4 million per year. Warmoth was the only shareholder at that time. In fact, Warmoth was the sole shareholder of Weekend Warrior from its incorporation until 2009, and he was the CEO and president during all the years at issue.

Managing Expectations?

The IRS disallowed most of Weekend Warrior's 2002 management fee deduction. The IRS recalculated it under Code Sec. 482 arm's-length principles, and also added forgone interest to its income under Code Sec. 7872. The IRS disallowed depreciation and other deductions, made various other adjustments, and imposed a Code Sec. 6662(h) 40-percent penalty.

The IRS made similar adjustments for 2003 and 2004. The adjustments flowed through to Warmoth as Weekend Warrior's sole shareholder. Essentially, the IRS argued that this arrangement was wholly lacking in arm's-length standards. It is hardly surprising that the IRS took this position. The flow of consideration was opaque at best.

Largely siding with the IRS, the Tax Court concluded that the management fees could not be deducted under Code Sec. 162. There was scant evidence showing what services were performed. The court found no basis on which to determine whether the management fees were reasonable and necessary.

Interestingly, the Tax Court noted that the IRS had abandoned its prior assertion of Code Sec. 6662(h)'s 40-percent penalty against Weekend Warrior. The court found that the IRS had met its burden of production that Warmoth and Weekend Warrior acted negligently. Moreover, the court found that the IRS had satisfied its burden regarding the substantial understatement penalty for Weekend Warrior in 2002 and Warmoth in 2003 and 2004.

Fun in the Sun

It is easy to get sidetracked in cases like this. Apart from the management fees, there were also other tax problems. There was a river boat, and there were entertainment expenses.

There was even an airplane. There was no log kept of the business use of the boat, and no mileage log kept to record the purpose of any of the flights. But shorn of toys and the like, the case is a good example of the mess that agreements between related parties can become.

There may have been nothing wrong in theory with the notion that one entity would provide services or goods to the other. In fact, there are legitimate business, liability and tax reasons that can make this an appropriate and even justifiable course of action. But the services or goods must *actually* be provided.

Plus, some attempt must be made to value them and to secure documentation that the arrangement was reasonable to both sides. All too often, related parties seem to throw caution to the wind.

In the related-party context, do not assume that if there is a problem someday, you can document it *then.* That is rarely possible. Even if it is possible to document the arrangement in a memorialization when the problem arises, it will rarely be considered in quite the same way or with the same degree of persuasiveness as one that is contemporaneously. Related parties should be documenting the situation much more completely than they would if they were dealing with unrelated parties. Use the latter as the standard.