Why Deductions for Related-Party Payments Are Scrutinized

By Robert W. Wood • Wood & Porter • San Francisco

The prevalence of pass-through vehicles over the past several decades has altered the traditional playing field. Tax advisors are used to advising about a coveted single layer of tax whenever that's structurally possible. Yet even with LLCs, partnerships and S corporations, the deductibility of payments can be critical.

One wants to reduce that entity's overall tax burden, a tax burden that will be passed through to the respective owners. Of course, in the M&A world, the C corporation context continues to prevail for large businesses.

In that world, a deduction is often even more important. The traditional dichotomy is between payments deductible at the corporate level that constitute income at the shareholder/executive level, thus achieving only one level of tax. We've covered the reasonable compensation doctrine in the past. [*See, e.g., Funny Money: Deducting "Reasonable" Compensation*, M&A TAX REP., Apr. 2009, at 5.]

The fortunes of this venerable tax doctrine have waxed and waned over the years. With the currently low qualified dividend rate, the consequences of two levels of tax may not be as Draconian as they have been historically. Yet few will argue that paying two levels of tax—even if one is at the 15-percent rate—is pleasant.

Leave It to the Accountants

All this was on my mind as I read the decidedly un-reasonable compensation-like case, *Mulcahy, Pauritsch, Salvador & Co., Ltd.*, 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 was 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 not wizards of Internal Revenue Code Section ("Code Sec.") 482 or even Code Sec. 162, and their erstwhile clever diversion of monies from one company to the next turned out not to be so clever after all.

Everyone Has Standards

For compensation to be deductible, the amount must be reasonable. Yet what is "reasonable" depends on the facts and circumstances of each case. In other words, exactly how the courts reach the conclusion of what is reasonable varies.

In the Seventh Circuit, where an appeal of *Mulcahy, Pauritsch, Salvador & Co., Ltd.*would go, the prevailing test is an "independent investor" test. The idea is to refer to the standards of an outside investor to assess whether payments are reasonable. [*See Exacto Spring*, CA-7, 99-2 USTC ¶50,964, 196 F3d 833 (1999).] The independent investor test asks whether a hypothetical independent investor would consider the rate of return on a particular investment to be far higher than he had any reason to expect.

If so, the compensation paid is presumptively reasonable. The presumption may be rebutted by evidence that the company's success was the result of extraneous factors. Such factors might include an unexpected discovery of oil under the company's land.

What about facts suggesting the company was trying to pay the owner/shareholder a disguised dividend and not salary? Not surprisingly, the disguised dividend stench is a constant feature of such cases in any circuit and under any test.

Let's Be Clever

Mulcahy, Pauritsch, Salvador & Co., Ltd. was an accounting and consulting firm founded by Edward Mulcahy, Michael Pauritsch and Phillip Salvador. Each had a 26-percent ownership interest, with the balance held by unrelated minority shareholders. The founders were the entire board, the sole officers and the firm's compensation committee.

The firm made substantial payments to three related entities: Financial Alternatives, Inc., PEM & Associates and MPS Limited. The first two were equally owned by all three founders, and the last was equally owned by Mulcahy and Salvador. Significantly, none of these three entities performed any services for the firm.

Each founder received compensation from the firm of approximately $100,000 annually. However, payments to the related entities—designated as "consulting fees"—were far larger. The documentation was less than perfect, but the founders claimed these payments represented compensation for the founders' services.

The payments totaled $891,570 in 2001, $866,143 in 2002, and $993,528 in 2003. It didn't seem coincidental that these payments effectively wiped out the firm's accumulated profits for each year. The disguised dividend taint was therefore strong.

Friendly Relations

As to what happened with the money in the hands of the related entities, that should be no surprise. The founders (as the compensation committee) allocated these related entity payments between themselves. They were not allocated *pro rata* in accordance with shareholders, but based on the hours each founder worked during the year. On top of the $100,000 in compensation the firm provided directly, the resulting payments to the founders were quite significant each year, exceeding $450,000 in one case.

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It's Deductible

President John F. Kennedy once said that the phrase "'it's deductible' should pass from our scene." The remark was directed primarily at lavish entertainment and the notorious three-martini lunch of the Mad Men era. But it seems equally apt in the reasonable compensation realm where no amount of pay seems beyond reach for some.

One key with any reasonable compensation case is often not whether the services were really extraordinary or really worth the high pay, but what *else* might be going on. Pay that is doled out in accordance with shareholdings in the context of a closely held company just seems so, well, *obvious*.

Here, the accounting firm deducted all the consulting fees and reduced its taxable income to something inconsequential, even creating a loss in one year. The IRS blanched and assessed taxes plus accuracy-related penalties. These were accountants after all!

Undeterred, the accountants went to Tax Court, but they would not find a sympathetic ear. First, these related entities didn't perform any services!

Who's Working?

It is axiomatic that ordinary and necessary business expenses can be deducted. In the case of payments for services, though, a deduction is available only when the services are *actually* rendered. The founders belatedly argued that the firm could deduct these payments, which were really for *their* services.

But the Tax Court ruled that even if these payments were for the founders' services, the firm had failed to show it was entitled to the deductions. The payments, one must recall, were all made to the *related entities* as entities, not to the individuals. It was only from the second-tier entities that the pay was allocated and then doled out to the founders.

It is not clear that these accountants would have fared any better had they scrapped the three other entities and paid themselves more healthily from their firm. As we shall see, they had problems with their expert testimony. In fact, little went right for them in their dispute. Had they used a shortest-distance direct line approach to get compensation in their hands, they might have had their collective eyes more firmly on the ball.

Not for Warren Buffet

Applying the independent investor test, the rate of return on investment was calculated based on annual net income, not net revenues. The firm reported taxable income of $11,249 for 2001, a loss of $53,271 for 2002 and zero for 2003. Accordingly, based on the rate of return on the firm's equity, the court found these amounts to be too low to create a presumption that the payments were reasonable compensation for the founders' services.

Moreover, the Tax Court held that the firm had failed to show the amounts it sought to deduct were comparable to those that would ordinarily be paid for like services by like enterprises under like circumstances. Sure, the accountants brought in an expert. However, the Tax Court found the statistics upon which the expert had relied irrelevant.

The expert's statistics showed payments to business owners, but not necessarily only as compensation for services. The court pointed out that these baseline figures may have reflected a return on the owner's investment in the business and other factors. The expert even failed to distinguish between reasonable amounts paid to an owner for services versus other types of payments.

Furthermore, the firm failed to show that the other benchmarks it offered (such as amounts paid to its other employees) were appropriate for comparison. The Tax Court even ruled that the consulting fees were not intended to compensate the founders for their services. The Tax Court acknowledged that the fees were paid from the related entities in rough proportion to the hours each founder worked. However, the overall structure of the payments demonstrated that they were profit distributions.

A Fatal Fact?

Not much went well for our three accountants, but the straw that broke the camel's back was simple: profits. The amount paid out as consulting fees was consistently all of the firm's accumulated profits for the year. If that didn't reflect the intent to eliminate taxable income, the court didn't know what did.

And that brought the court to penalties, and it should be no surprise that the court upheld. The fake consulting fees produced a substantial understatement of income in each year. The firm failed to show reasonable cause or good faith, and that meant penalties were appropriate. The firm didn't even demonstrate that it made any genuine effort to determine its true tax liability.

The Bitter End

The tax literature is filled with cases that have more extreme facts and more flailing attempts at tax acumen. Yet it is undeniable, as the Tax Court nearly seemed to be muttering throughout its opinion that, hey, these guys are accountants!