C Corporate Tax Planning; Management Fees and Reasonable Compensation - A Roadmap of What Not to Do

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Overview

A recent U.S. Tax Court decision is instructive on how carelessness in tax planning with respect to a C corporation can prove to be costly. Maintaining detailed books and records; properly invoicing for services rendered to the corporation; carefully planning for and specifying how management fees are to be set and compensated; and paying reasonable compensation are all key components to how a C corporation should be operated. But, when those aspects of C corporate operational life are not observed, a bad tax outcome is the result. A recent U.S. Tax Court opinion makes that point clear.

Key aspects of operating a C corporation and the perils of sloppiness – it's the focus of today's post.

Corporate Deductions

Treas. Reg. §1.162-7(a) allows a deduction for ordinary and necessary business expenses that are paid or incurred in carrying on a trade or business. *See also I.R.C. §162(a)(1).* This includes a reasonable allowance for salaries or other compensation for personal services that are actually rendered to the corporation. *Treas. Reg. §1.162-7(a).* That's a key point in the C (and S) corporation context – compensation must be "reasonable" to be deductible. Management fees must meet also meet the ordinary and necessary test. They are part of overall compensation and, overall, compensation must be reasonable – an amount that would typically be paid for similar services by similar businesses under similar circumstances. The reasonableness test is applied on an individual-by-individual basis rather than whether, for instance, the total compensation to a group of shareholders is reasonable. In addition, payment must be for actual services. It must not be a distribution to the shareholders that is disguised as deductible compensation.

Deducting management fees.

The issue of whether compensation is deductible as payment for services rendered to the corporation is a particular sticky one when the corporation doesn't have very many shareholders. In that instance, the courts tend to view the situation lending itself to a greater probability that there is a lack of bargaining at arms' length between the employees (e.g., shareholders) and the corporate board. The tendency, at least in the view of the IRS is that "management fees" are not really paid purely for services rendered to the corporation. But, the analysis is based on a facts and circumstances test containing multiple factors – the corporation's history of distributions to the holders of the corporate equity; whether the management fee paid to a shareholder is proportional to that shareholder's percentage interest in the corporation; whether the services performed were via the shareholder's controlled entity and the fee was paid to the shareholder; whether the management fee was negotiated at the beginning of the tax year and paid throughout the year as services were performed; the level of corporate taxable income after deducting management fees that were paid out; whether there was a structure in place for determining the level of management fees.

Recent Tax Court Case

In *Aspro, Inc. v. Comr., T.C. Memo. 2021-8,* the petitioner was a C corporation in the asphalt paving business incorporated under Iowa law with its principal place of business in Iowa. The petitioner had three shareholders and did not declare or distribute any dividends to them during the tax years in issue (2012-2014) or in any prior year. This was despite the petitioner having significant profits before setting management fees. Thus, the shareholders didn't receive any return on their equity investment. The petitioner did not enter into any written management or consulting services agreements with any of its shareholders. Also, there was no management fee rate or billing structure negotiated or agreed to between the shareholders and the petitioner at the beginning of any of the years in issue.

None of the shareholders invoiced or billed the petitioner for any services provided indirectly via other legal entities that the shareholders controlled. Instead, the petitioner's Board of Directors would approve the management fees to be paid to the shareholders at a board meeting later in the tax year, when the Board had a better idea how the company was going to perform and how much earnings the company should retain. However, the Board minutes did not reflect how the determinations were made. The Board did not attempt to value or quantify any of the services performed on its behalf and simply approved a lump-sum management fee for each shareholder for each year. The amounts were not determined after considering the services performed and their values. There was no correlation between management fees paid and services rendered. In total, the shareholders received management fees exceeding $1 million every year for the years in issue. The management fees were simply paid after-the-fact in an attempt to zero-out the petitioner's taxable income.

The IRS completely denied the petitioner's claimed deductions for management fees (and amounts the petitioner claimed for the domestic production activities deduction) for the years in issue. The Tax Court upheld the IRS position denying the deductions.

The Tax Court determined that the petitioner failed to prove that the management fees were ordinary and necessary business expenses and reasonable in accordance with Treas. Reg. §1.162-7. Based on the facts and circumstances, the Tax Court concluded that the absence of the dividend payments where the petitioner had available profits created an inference that at least some of the compensation represented a distribution with respect to corporate stock. While the management fees loosely corresponded to each shareholder's percentage interest, the Tax Court inferred that the shareholders were receiving disguised distributions based on each shareholder's equity interest.

As for the services rendered to the corporation via the shareholders' controlled entities, the Tax Court noted that if the services were to be compensated, the petitioner should have invoiced directly for the services. The services, as a result, did not provide even indirect support for the management fees the petitioner paid to its shareholders.

The Tax Court also noted that the management fees were not established in advance for services to be provided and there was no management agreement that evidenced any type of arms' length negotiation to support a fee structure that the parties bargained for. The shareholders also could not explain how the management fees were determined, and the corporate President (and one of petitioner's Board members) displayed a misunderstanding of the nature of deductible management fees and stock distributions.

The Tax Court also pointed out that the effect of the deduction for management fees was to create little taxable income to the petitioner. That, the Tax Court believed, indicated that the fees were disguised distributions. The Tax Court further determined that the petitioner's President rendered no services to the petitioner other than being the president and, as such was already overcompensated by his base salary and bonus totaling approximately $500,000 annually. Thus, the additional management fee was completely unreasonable as to him.

Reasonable Compensation

As noted above, to be deductible, compensation in the corporate context must be "reasonable." For starters, that means that the corporation must establish the connection between the services that are performed and the compensation (including management fees) that are paid. In *AsPro, Inc.,* the corporation didn't meet that burden. In *Aspro, Inc.,* the Tax Court looked at numerous factors to determine reasonableness – the employee's qualifications; the work performed for the corporation; the size of the corporation and the complexity of business operations; how salaries compare to corporate gross and net income; general economic conditions in the corporation's industry; how compensation to the shareholders stacked-up against corporate distributions to those same shareholders; whether the compensation packages for the shareholders was comparable positions in similar businesses; overall salary policy; and past compensation history.

The Tax Court also noted that some of the U.S. Circuit Courts of Appeal don't analyze the issue of reasonable compensation based on multiple factors, but rather the amount of compensation an independent investor would pay. The Circuit Court to which *Aspro Inc*. would be appealable has not settled on the approach it would use to determine reasonable compensation in the corporate context.

Conclusion

The *Aspro, Inc.* case is a textbook roadmap case of how to screw up C corporate tax planning. There was no detailed, thought-out plan backing up the management fees, no clarity or documentation of what services were rendered and how frequently they were rendered, and no substantiation of whether the services were necessary to be paid for in the petitioner's industry. There was no management agreement that listed the services to be provided by each contracting party, and no documentation of the level of pay for those services.

The complete lack of planning and associated documentation in *Aspro, Inc.* resulted in a tax bill exceeding $1.5 million, plus interest.

Truly a roadmap for disaster.