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TAX LAW

NINTH CIRCUIT REJECTS PRESUMPTION OF DISGUISED DIVIDENDS SOLELY BASED ON A LACK OF DIVIDEND PAYMENTS

I. INTRODUCTION

In *Elliots, Inc. v. Commissioner,*[1] the Ninth Circuit, rejected the *McCandless* automatic dividend[2] rule and held that the absence of dividends, combined with the presence of a sole officer-shareholder of a profitable corporation, does not automatically lead to the presumption that compensation payments necessarily contain disguised dividends.[3]

Elliots, Inc. (the corporation) was an Idaho corporation engaged in the business of selling equipment manufactured by John Deere Company.[4] Edward G. Elliot (Elliot) served as the chief executive officer since the entity was incorporated in 1952 and as the sole shareholder since 1954.[5] The corporation, though

1. 716 F.2d 1241 (9th Cir. 1983) (per Hug, J.; the other panel members were Skopil, J. and Fletcher, J.).

2. Charles McCandless Tile Serv. v. United States, 422 F.2d 1336 (Ct. Cl. 1970). In *McCandless*, the Court of Claims found that compensation payments, although reasonable in amount, "necessarily" contained disguised dividends. The court presumed that dividends were being hidden because the corporation had been profitable yet had not paid any dividends since it was incorporated. *Id.* at 1339-40. The label "automatic dividend" was first applied to the *McCandless* case in Holden, *Has Court of Claims Adopted an "Automatic Dividend" Rule in Compensation Cases?* 32 J. TAX 331 (1970). The term implies application beyond the facts of *McCandless*.

3. The court reviewed the Tax Court's definition and application of the factors that determine reasonable compensation. The court reversed the finding that the compensation received was intended to distribute profits and remanded the case for reconsideration under the analysis outlined in the opinion. 716 F.2d at 1248.

4. *Id.* at 1242. The corporation experienced gross sales of $500,000 in 1952 when it was originally incorporated and expanded to gross sales of over 5 million dollars with 40 employees in 1975. *Id.*

5. *Id.* His duties included total managerial responsibility, the making of ultimate policy decisions, the roles of sales and credit manager and decision making for the parts and service departments. Elliot worked an average of 80 hours per week. *Id.*

profitable,[6] never paid a dividend.[7]

The corporation had paid Elliot a base salary of $2000 per month for several years, including the years 1975 and 1976 which were the years questioned in the IRS's notice of deficiency.[8] In addition, Elliot received bonuses equivalent to fifty percent of the corporation's net profits before deduction of income taxes and management bonuses.[9] The bonuses were based on a predetermined formula, consistently applied since the time of incorporation.[10]

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6. Elliots Inc. v. Comm'r, 40 T.C.M.(CCH) 802, 804 (1980), *rev'd* 716 F.2d 1241 (9th Cir. 1983). Elliots Inc.'s net profits were as follows:

Fiscal Year Ending February 28	Net Profits*	After Tax Profits
1968	$ 25,090	$19,715
1969	5,635	4,206
1970	27,042	19,190
1971	77,569	43,934
1972	59,873	36,713
1973	57,951	37,268
1974	112,536	63,674
1975	157,074	88,969
1976	169,663	98,297
1977	129,696	78,250
1978	59,052	42,860

*After salary to Mr. Elliot and before State and Federal Income Taxes.

40 T.C.M.(CCH) at 804.

7. 716 F.2d at 1247.

8. *Id.* at 1242.

9. *Id.* Mr. Elliot was paid as president and general manager of Elliots Inc. as follows:

Fiscal Year Ending February 28	Total Compensation Paid to Mr. Elliott
1968	$ 42,800
1969	19,600
1970	34,035
1971	84,450
1972	68,323
1973	66,401
1974	136,536
1975	181,074
1976	193,663
1977	153,696
1978	83,052

40 T.C.M.(CCH) at 804.

10. *Id.* The ability to show that contingent compensation is based on a formula, that has been in effect for an extended period of time, is important and good record keeping can make the difference. The crucial issue seems to be that the system was predeter-

The corporation deducted $181,074 and $191,633 as compensation paid to Elliot for the fiscal years ending in 1975 and 1976 respectively.[11] However, the Internal Revenue Service issued a notice of deficiency and limited the deduction to $65,000 for each fiscal year.[12] The corporation petitioned the Tax Court for a redetermination of liability and subsequently the deficiency was reduced. However, the court determined that the payments to the employee-shareholder were both compensation for personal services and disguised dividends and concluded that the total amount paid was in excess of reasonable compensation.[13] The corporation appealed the Tax Court's holding regarding the level of reasonable compensation to the Ninth Circuit, contending that the court ignored the amount of compensation

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mined and the inference that the method is being put forward only as a result of litigation should be avoided. The Ninth Circuit advanced such a perspective in Pacific Grains v. Comm'r, 399 F.2d 603 (9th Cir. 1968):

> The failure of the taxpayer's Board of Directors to earmark the funds as being in part for prior services and the lack of any showing as to what percentage of the compensation was intended for the respective periods give support to the Commissioner's contention that the taxpayer's theory of compensation for prior services was only an afterthought developed at a time when the reasonableness of the compensation was already under attack.

399 F.2d at 606.

11. 716 F.2d at 1242.

12. *Id.* The Commissioner's notice of deficiency contained the following explanation:

> It is determined that compensation paid to Edward G. Elliot during the taxable years ended 2/28/75 and 2/28/76 is excessive in amounts of $116,073.71 and 128,662.91, respectively. Such amounts exceed a reasonable allowance for salaries and other compensation for personal services rendered within the ambit of section 162 of the Internal Revenue Code.

40 T.C.M.(CCH) at 809.

13. 40 T.C.M.(CCH) at 813. The Tax Court did not allow the fact that Elliot's compensation was based on a contingent formula to enter into their analysis:

> Based on the record as a whole, and considering (1) the nature of the work done by Mr. Elliot, (2) the hours he worked, (3) the lack of difference in his work in the years here in issue and prior years, (4) the fact that in many instances salaries paid by other John Deere dealers were paid to more than one individual, and (5) the level of salaries paid by petitioner to executive employees other than Mr. Elliot, we conclude that reasonable compensation for petitioner's fiscal years ending February 28, 1975 and February 28, 1976 was $120,000 and $125,000 respectively. We therefore sustain respondent's disallowance of petitioner's claimed deduction for compensation paid to Mr. Elliot which is in excess of these amounts.

Id.

paid to Elliot in prior and succeeding years under the formula.[14]

II. BACKGROUND

Section 162(a)(1) of the Internal Revenue Code allows reasonable compensation payments but not dividend payments to be deducted as ordinary and necessary business expenses by corporations.[15] Because dividends are includable in the gross income of the recipient and also as corporate distributions out of current or accumulated earnings and profits, an incentive exists for labeling the payments as compensation to avoid a double tax on the distribution.[16] However, shareholder-employees are taxed at the same level for both dividends and wages regardless of the payment's characterization.[17] Yet, officer-shareholders with significant holdings may prefer to receive dividends in the guise of compensation in order to further the interests of the corporation and their own interests as shareholders.

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14. 716 F.2d at 1242. *See also* Brief for Appellant at 4, 716 F.2d 1241.

15. I.R.C. § 162(a)(1)(West 1978). The section provides:
"(a) In general.- There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including- (1) a reasonable allowance for salaries or other compensation for personal services actually rendered. . . ." *Id.*

The issue in most cases is "what is reasonable?" Although subordinate to the Internal Revenue Code, the Treasury Regulations can be looked to for interpretive aid. The regulation illustrates practical application of the code:

> In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

Treas. Reg. § 1.162-7(b)(3), T.D. 6500, 1983-15 C.B. 658. Further interpretation of the Treasury Regulation is found in judicial interpretation of what constitutes "like services under like circumstances." This is essentially a fact question.

16. I.R.C. § 316(a) and § 301(c)(1)(West 1978).

17. 716 F.2d at 1243 n.2.

> Moreover, for payments made between 1971 and 1981, as is the case here, a high income recipient has a strong incentive to characterize such payments as compensation rather than dividends: pre-1982 dividends are taxable at a maximum rate of 70% while the maximum tax rate for wages received between 1971 and 1981 is 50%. 26 U.S.C. § 1 (amended 1983) and § 1348 (repealed 1981). (Since 1982, the maximum tax rate for both wages and dividends has been 50%. 26 U.S.C. § 1 (1982)).

Id.

The determination of reasonable compensation has followed the two prong test contained in Treasury Regulation section 1.162-7(a).[18] Under the first prong of this test, it is necessary to determine if the amount of compensation is reasonable.[19] Although the interpretation by courts as to what is reasonable has varied from case to case, several guidelines are important in making the reasonableness interpretation.[20] These include the employee's qualifications, the nature of the position, complexities of the business and industry customs and economic conditions in general.[21]

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18. "The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services." Treas. Reg. § 1.162-7(a), T.D. 6500, 1983-15 C.B. 657.

19. Treas. Reg. § 1.162-7(b)(3), T.D. 6500, 1983-15 C.B. 658. An example of the approach utilizing the amount paid as a gauge of reasonableness is found in Klamath Med. Serv. Bureau v. Comm'r, 261 F.2d 842 (9th Cir. 1959)(the corporation sold prepaid medical plans and contracted to pay physicians for their services according to a schedule of base fees under a complex formula.):

> The Tax Court specifically found that while the fee schedule was unreasonably low when compared to like services and procedures and compensation charged therefor by physicians in private practice, it was equitable and fair when the lessened costs to doctors rendering services under the plan (which lessened costs are attributable to taxpayer's operation) were considered. None of the fees set were unreasonable in amount, and it was held that 100 percent of the billings of physicians constituted reasonable compensation for the services for which taxpayer was billed.

Id. at 844.

20. Miller Mfg. Co. v. Comm'r, 149 F.2d 421 (4th Cir. 1945). "These facts and circumstances vary so widely that each corporate tub must more or less stand upon its own bottom." *Id.* at 423.

21. A much cited summary of factors to be considered is found in Mayson Mfg. Co. v. Comm'r, 178 F.2d 115 (6th Cir. 1949):

> [I]t is well settled that several basic factors should be considered by the Court in reaching its decision in any particular case. Such factors include the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years.

Id. at 119. The Court of Claims laid out a set of guidelines in Irby Constr. Co. v. United States, 290 F.2d 824 (1961):

> The inquiry as to the reasonableness of compensation in a

The second prong analyzes whether the payments were made "purely for services."[22] It examines "intent" in specific situations where the compensation was paid to persons with what appear to be less than arms-length relationships, such as family members or employee-shareholders.[23] However, the lack of divi-

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> given instance is not without some guides. At various times courts have looked to such things as the amounts paid by similar enterprises for services of a like character; the type and extent of services rendered by the employee; the scarcity of qualified employees for the position; the prior earning capacity of the employee; the peculiar characteristics of the taxpayer's business, and the general economic conditions of the period.

Id. at 826.

22. Payments in excess of 100% of the amount agreed upon by contract have been disallowed as distributions of corporate income. *Klamath*, 261 F.2d at 845. In Klamath Med.Serv. Bureau v. Comm'r, 29 T.C. 339 (1957),*aff'd* 261 F.2d at 845, the Tax Court examined whether the payments were purely for services as follows:

> We think it must be concluded from this record that, with respect to that portion of the payments here involved which exceeds 100 per cent of the billings of petitioner's staff doctors, such payments were distributions of petitioner's profits and earnings. We are led to this conclusion because of the contract under which petitioner was bound to pay its member doctors for their services rendered. That instrument is ambiguous with respect to the compensation for such services. It does not specifically provide for the payment of over 100 per cent of the billings for such services but does provide specifically that the billings be in accordance with its fee schedule. . . . It seems clear from this that petitioner has contracted with its member physicians that they will render their services to petitioner for fees equal to its fee schedule regardless of the fact that such fees may be in some instances below reasonable compensation therefor.

29 T.C. at 347-48.

Another indicator that the payment is not "purely for services" is that the only employees receiving bonuses are employee-stockholders and the bonuses received are in proportion to their holdings:

> Each of the bonus payments and administrative salary payments made by Nor-Cal to its four officer-shareholders during the year in issue was exactly proportionate to the recipient's respective stockholding in Nor-Cal. Taxpayer also employed three other insurance adjusters during 1967 but none of those individuals received bonuses in any way comparable to the officer-shareholders.

Nor-Cal Adjusters v. Comm'r, 503 F.2d 359, 361 (9th Cir. 1974).

23. In *Nor-Cal*, the factors that were determinative in finding that the compensation at issue was not payment for services actually rendered were:

> 1. The bonuses were in exact proportion to the officer's stockholdings;
>
> 2. Payments were in lump sums rather than as the services were rendered;

dends in and of itself was not indicative of a disguised dividend until *McCandless Tile Service v. Commissioner.*[24]

In *McCandless*, the Court of Claims[25] held that the amounts

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> 3. There was a complete absence of formal dividend distributions by an expanding corporation;
> 4. The system of bonuses were completely unstructured; i.e., bonuses were computed periodically throughout the year on no apparent pre-set basis;
> 5. Taxpayers consistently negligible taxable income was an indication that the bonus system was based on funds available rather than services rendered;
> 6. The stock redemption agreement between Nor-Cal and Hobson [Hobson was president of Nor-Cal and a 35% shareholder.]; and
> 7. Bonus payments were made only to the officer-stockholders.

503 F.2d at 362.

24. 422 F.2d at 1339. *See* Bringwald, Inc. v. United States, 334 F.2d 639 (Ct.Cl. 1964). "Certainly the mere fact that a corporation has never paid any dividend would not, in and of itself, justify the conclusion that the salaries paid to an employee shareholder were a distribution of a dividend. There may be varied business reasons for the corporation to refrain from distributing dividends." *Id.* at 644.

25. There are three forums available to the taxpayer who wishes to fight a notice of deficiency: the Tax Court of the United States, the United States district courts and the United States Court of Claims. There are no jurisdictional requirements or limitations as to the amount in controversy for any of the three courts. The district courts and Court of Claims handle any federal tax assessment issues. The Tax Court's jurisdiction is limited to cases involving income, estate, gift and excess profit taxes. The most important difference is that the taxpayer must pay the disputed tax in full before an action maybe brought in the Court of Claims or the district court. A jury trial is available only in the district court. L. PONDER, UNITED STATES TAX COURT PRACTICE AND PROCEDURE, 24-27 (1976).

The Tax Court views itself as a national court. Originally this attitude was reflected in Arthur L. Lawrence v. Comm'r, 27 T.C. 713, 716-20(1957), *rev'd* 258 F.2d 562 (9th Cir. 1958), *overruled*, 54 T.C. 742, 757(1970):

> The Tax Court has always believed that Congress intended it to decide all cases uniformly, regardless of where, in its nation-wide jurisdiction, they may arise, and that it could not perform its assigned functions properly were it to decide one case one way and another differently merely because appeals in such cases might go to the different Courts of Appeals. . . .

27 T.C. at 718.

That viewpoint was modified in Jack E. Golsen v. Comm'r, 54 T.C. 742, 757 (1970):

> Notwithstanding a number of the considerations which originally led us to that decision [*Lawrence*], it is our best judgment that better judicial administration. [sic] (footnote ommitted) requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone (footnote ommitted).

Id. The taxpayer must examine the precedent in the courts of appeals in the circuit in paid as compensation, although reasonable, contained a disguised dividend[26] because the corporation had not declared any dividends since its formation.[27] Two fifty-percent officer shareholders were paid compensation equal to fifty-percent of the corporation's net profits.[28] The court recognized the outstanding management ability of the two employee-stockholders and conceded that the corporation's success and large profits were attributable to their hard work and dedication.[29] The unique re-

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which the case may be brought. These prior decisions will be influential to a varying degree depending on the court chosen. The district courts pay close attention to the views of the higher federal courts. The Court of Claims has overruled itself on more than one occassion and so may rule favorably despite a prior adverse decision. B. Lane and J. Hamovit, The Preparation of Tax Refund Cases in the District Courts and Court of Claims, 12-25 (1964). A Court of Claims decision, such as *McCandless*, could only be appealed to the Supreme Court at the time the *Elliots* litigation was initiated. However, decisions of all three courts can be appealed to courts of appeals now, which will alter some of the precedential value of future decisions of the various courts.

26. Based on an examination of the entire record, the court determined that there should have been a 15% return on equity capital. This figure was based on net profits before salaries and federal income tax. The court concluded that this 15% return had been distributed via the compensation payments. 422 F.2d at 1340.

27. The Ninth Circuit took a similar approach in *Pacific Grains*. The court made the following observations regarding profitability and dividends:

> The taxpayer notes that the business was doing well with a high rate of return on the investment. This success certainly presents an argument that high salaries might be justified. However, it is also consistent with the Commissioner's argument that the taxpayer should have been paying dividends and that the high salary paid to its sole shareholder was merely a method of draining off corporate profits at a tax advantage.

399 F.2d at 606. The court decided that "[r]ather than declare dividends, the Board paid him a high salary." *Id.* at 607. The Ninth Circuit's analysis in *Elliot* radically alters this "either-or" approach. 716 F.2d at 1246.

28. The court stated that there was some indication, based on review of a "comparable company," that the McCandlesses were entitled to greater compensation. 422 F.2d at 1339.

29. *Id.* The court reasoned as follows:

> There can be little doubt on the record here that plaintiff's impressive net profit showing during the years in question has been due in large measure to the long experience, outstanding executive abilities, and hard work of Charles S. and Charles L. McCandless. The evidence is persuasive, moreover, that it would be extremely difficult for plaintiff to replace these two officers within any reasonable period of time. In short, the McCandlesses have placed [sic] a critical role in, and are largely responsible for, plaintiff's extremely successful operations.

Id. The *McCandless* court also attributed the success of the company to the shareholder roles: "supplying risk capital, assuming corporate obligations and participating in corporate decisions." *Id.* at 1340. This focus may be responsible for the unique result in *McCandless*. After all, the shareholder-employee is entitled to wages as an employee, which sult of this case turned on the emphasis the court gave to the lack of dividends.[30] However, *McCandless* has been the subject of much criticism regarding the application of the "automatic dividend" rule.[31]

The *McCandless* court applied the language of section 1.162-7(b)(1) of the Treasury Regulations[32] which cautions that where salaries are not reasonable in comparison to those of similar businesses and the payments correspond to the percentage of

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are an immediate return on time devoted to the job. He is also entitled to a return on his investment as a shareholder but it may not always be in his best interest to receive an immediate return as a dividend. He may prefer, if given the choice, to reinvest profits and gain a larger future return. The *McCandless* case, strictly interpreted, requires that the compensation reflect a return on both roles if no dividends are paid. If the compensation was found to be in excess of reasonable, the labeling of the excess as a disguised dividend would not cut into the amount determined to be reasonable for the employee role. However, a less equitable result is obtained if the amount is determined to be reasonable and therefore the mandatory dividend has to be supplied by subtracting it from the reasonable compensation for the employee role. This results in a sacrifice of the compensation for the employee role to satisfy the shareholder role. This approach is tentative at best when the amount of influence that a shareholder has on the success of a corporation is examined.

The shareholder's *role* generally includes voting for directors and investing money but not direct responsibility for fine tuning an organization. One commentator has pointed out that "[i]t is difficult to accept the argument that the stockholders were responsible for the success of the company and should be compensated therefore as a result of their participation in corporate decisions. Stockholders as such are compensated for the use of their money." O'Neill, *Reasonable, but Nondeductible, "Compensation"*? 57 A.B.A.J. 82, 84 (1971). The segregation of the distinct roles of investor-shareholder and officer-employee is even more important in a sole shareholder case such as *Elliots*.

30. "We think it clear that any return on equity capital is so conspicuous by its absence as to indicate, given all the facts, that the purported compensation payments necessarily contained a distribution of corporate earnings within." 422 F.2d at 1339-40.

31. Coggin, *The Status of the McCandless Doctrine*, 55 TAXES 720 (1976); Walthall, *McCandless-Implications for Compensation Planning and Dividend Policy*, 6 CUM. L. REV. 1 (1975); Note, *Reasonable Compensation*, 26 STAN. L. REV. 441 (1973).

32. The Treasury Regulation states in part:

> Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem *likely* (emphasis added) that the salaries are not paid wholly for services rendered, but that the *excessive* (emphasis added) payments are a distribution of earnings on the stock.

Treas. Reg. § 1.162-7(b)(1).

stockholdings, it is "likely" that the "excessive" compensation is a disguised dividend.[33] The court focused on the lack of dividends and ignored their finding that the compensation was reasonable. Despite the lack of "excessive" payments, their scrutiny uncovered disguised dividends.[34] *McCandless* has been frequently cited by the government[35] in disguised dividend cases for various propositions, however, no court has automatically applied the rule as was done in *McCandless.*[36]

In 1974, the Ninth Circuit addressed the issue of contingent compensation and a lack of dividends in *Nor-Cal Adjusters v. Commissioner.*[37] Significantly, the court did not cite *McCand-*

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33. 422 F.2d at 1339.

34. *Id.* at 1340.

> Implicit in our earlier discussion of reasonable compensation is the attitude that a corporation's highly efficient operation and its clearly demonstrated profit-making ability justify substantial compensation to the officers responsible therefore. As such performance justifies substantial compensation, we are of the further view that it also justifies a substantial investment return. Perhaps this is especially true with respect to a closely held corporation where the opportunity to distribute corporate earnings as compensation is most readily available and, as here, compensation is in fact in proportion to the stockholdings of the principle stockholders.

Id.

35. In *Elliots,* the government utilized *McCandless* for both the proposition that the lack of dividends was strong evidence in favor of a finding of disguised dividends and that 15% of the company profits were dividends, not compensation. 40 T.C.M.(CCH) at 810. However, the Commissioner dropped the 15% figure in the brief for the appeal to the Ninth Circuit. "A substantial return on investment for stockholders would ordinarily be expected from such successful operations and the absence of a profit distribution to stockholder justifies the inference that some of the purported compensation really represents a distribution of taxpayer's profits." Brief for Appellee at 28, *Elliots,* 716 F.2d 1241. Notice the similarity to the language in *McCandless. See supra* note 34.

36. The lack of dividends paid by a group of profitable companies was taken as an inference that the compensation contained a partial distribution of profits. Charles Schneider and Co. v. Comm'r, 500 F.2d 148 (8th Cir. 1974). The *Schneider* court cited *McCandless* for this proposition but did not automatically conclude that part of the compensation was not purely for services on that basis alone. The court pointed out that the contingent bonuses based on percentages of annual net sales and profits left little to be paid out as dividends even though the companies were profitable. The fact that the employee-shareholder spent less time at work and his pay increased during that period was also seen as significant. Comparisons made to prevailing rates paid to persons in similar positions within the furniture and upholstery manufacturing industry showed the compensation to be grossly disproportionate to similar sized companies. The bonuses were two to three times what was paid in the industry. In this factual setting, the lack of dividends was indicative of disguised dividends, but not controlling. 500 F.2d at 153-54.

37. 503 F.2d at 361. *Nor-Cal* involved contingent bonuses to officer-shareholders in

less, although the Tax Court opinion which was affirmed did refer to the case.[38]

In *Nor-Cal,* the Tax Court cited *McCandless* for the proposition that the compensation, though reasonable, could still contain a disguised dividend.[39] The Ninth Circuit gave cursory treatment to the Tax Court's findings and affirmed the decision.[40] The Ninth Circuit's language[41] closely resembled a *McCandless* analysis.[42]

In *Edwins, Inc. v. United States,*[43] the Seventh Circuit relegated the importance of the lack of dividends to that of a "red flag" and stressed that it was only one factor in determining reasonable compensation.[44] This treatment of the automatic dividend rule curbed the effects of *McCandless* as precedent although it did not expressly reject the rule.

In *Giles Industries v. United States,*[45] the Court of Claims

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exact proportion to stockholdings and no dividends were paid. The lack of dividends was not given overriding significance in the reasonableness determination and the bonuses paid in proportion to the stockholdings were given equal emphasis. *Id.* at 361-62.

38. Nor-Cal Adjusters v. Comm'r, 30 T.C.M.(CCH) 837, 842 (1971), *aff'd* 503 F.2d 359 (9th Cir. 1974).

39. 30 T.C.M.(CCH) at 841.

40. 503 F.2d at 361.

41. *See supra* note 22, *Nor-Cal.* However, in the *Elliots* case, the commissioner presented the proposition that because Elliot was the sole shareholder, there could be no arms-length agreement regarding a percentage of profits bonus. 40 T.C.M.(CCH) at 810. This same argument was put forth on appeal. Brief for Appellee at 26, 716 F.2d 1241. Additionally, the *McCandless* case was used for the proposition that the lack of dividends is strong evidence of disguised dividends. 40 T.C.M.(CCH) at 810. On appeal, this assertion was still made by the commissioner. Brief for Appellee at 28, 716 F.2d 1241. The commissioner contended that at least 15% of the earnings and profits must be disguised dividends,based on the *McCandless* formula. 40 T.C.M.(CCH) at 810. The 15% estimate was dropped on appeal. These three contentions can be made without analyzing the facts of a case beyond noticing that the corporation has a sole-shareholder employee paid on a contingent basis and that no dividends are paid.

42. "Bonuses had been paid to taxpayer's officer-shareholders in every year of its existence through the year in question. From the time appellant was originally incorporated to the filing of this action, Nor-Cal has neither formally declared nor paid a dividend to any of its shareholders." *Id.* The avoidance of a citation to *McCandless* could have been premised on the fact that because the bonuses were so obviously tied to the proportion of stockholdings, the court had no need to formally address the lack of dividends in the McCandless sense.

43. 501 F.2d 675 (7th Cir. 1974). In *Edwins,* two fifty-percent officer-shareholders each received a twenty percent bonus from net income before taxes. *Id.* at 676.

44. *Id.* at 677 n.5. The court did not directly reject *McCandless* by name. *Id.* at 678.

45. 496 F.2d 556 (Ct.Cl. 1974). In *Giles,* the two fifty-percent employee-shareholders

modified its subsequent application of the *McCandless* holding and exmphasized that in order to apply the automatic dividend rule, the facts must parallel those in *McCandless.*[46] The court went so far as to outline specific factors necessary for the application of the automatic dividend rule.[47]

III. THE COURT'S ANALYSIS

In rejecting the *McCandless* automatic dividend rule, the Ninth Circuit dismissed the government's argument that because the profitable corporation had never paid a dividend to the shareholder-officer, part of the compensation must be considered a disguised dividend.

The court rejected *McCandless* for three major reasons. First, there is no statute which requires profitable corporations to pay dividends.[48] This is an acknowledgment that the distribution of dividends is not mandatory and that Congress intended that excessive profits accumulated under such circumstances are to be dealt with via the accumulated earnings tax.[49]

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received compensation equal to fifty percent of the net profits before taxes.

46. *Id.* at 567-68. *See* Coggin, *The Status of the McCandless Doctrine*, 55 TAXES 720 (1976).

47. 496 F.2d at 567-68. As presented by one commentator:

> These distinguishing factors may be briefly summarized as follows:
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> 1. The presence of dividend payments in any year;
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> 2. Certain of the stockholders are not in fact officers of the corporation;
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> 3. Compensation paid to the stockholder-officers is not proportional to their respective stockholdings.
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> 4. Divergence in the shareholdings between the officer-shareholders and;
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> 5. Compensation paid to stockholder-officers amount to less than 50% of the corporation's net profits (before their compensation and federal income tax).

Coggin, *supra* note 46 at 731.

48. 716 F.2d at 1244.

49. 26 I.R.C. § 531-37 (West 1978).

> 532(a) General rule- The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation by permitting earnings and profits to accumulate instead of being divided or distributed. *Id.* at 532(a). 533(a)- Unreasonable accumulation determinative of purpose- For purposes of section 532, the fact that the earnings and profits of a corporation

Secondly, the court labeled the premise that the shareholders of a profitable corporation will demand dividends to be faulty. The court noted that a corporation has the right to reinvest profits if shareholders prefer to realize investment returns through appreciation.[50]

Lastly, the court stated that it may be in the best interest of a closely held corporation to maintain a conservative dividend policy because retention and reinvestment may be the most reasonable source of financing and credit due to limited access to capital.[51]

Next, the court addressed application of the two prong analysis of reasonableness and compensatory purpose.[52] The court explained that where the evidence shows a failure to pay a dividend, but no other evidence of intent to hide dividends in compensation, the focus of the inquiry will be limited to reasonableness under the first prong.[53] Such an inquiry can be based on an objective standard by examining salaries paid for comparable positions in similar corporations.[54]

The court acknowledged the difficulty of establishing proof of intent for the second prong. A subjective analysis is required to determine whether there was a compensatory purpose. To cir-

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> are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

Id. at 533(a).

50. 716 F.2d at 1244. It is interesting to note that under the *McCandless* doctrine, profit reflects the ability to pay a dividend and the lack of one indicates a disguised distribution. However, from a different perspective, profit can be viewed as a positive factor in showing that the compensation scheme has not depleted the capital to the point where no dividend *could* be paid. This perspective will still closely scrutinize compensation that appears to be depleting all the profits at a tax advantage. *See Nor-Cal,* 503 F.2d 359. This divergence in approach and reasoning is based in a difference in assumptions as to what an independent investor would consider to be reasonable. The *McCandless* doctrine concludes that all investors want the maximum dividends payable. The instant opinion reflects a more flexible approach which takes into account the need for a small business to reserve capital as well as produce sufficient earnings on equity. *See* Note, *supra* note 31.

51. 716 F.2d at 1244. *See* Walthall, *supra* note 31.

52. 716 F.2d at 1244. *See supra* note 18.

53. 716 F.2d at 1244.

54. Treas. Reg. § 1.162-7(b)(1). *See supra* note 32.

cumvent this difficulty, the court declared that intent can be inferred if the amount is first determined to be reasonable under the first prong.[55] The court noted that, to a great extent, this approach avoids scrutiny of subjective intent.

The court noted that by allowing the first prong of the test to subsume the second prong, the analysis will scrutinize compensatory intent secondarily and only if there is evidence that an otherwise reasonable amount contains a disguised dividend. Such evidence will be the exception and not the rule.[56]

The court stated that the analysis of whether the compensation was reasonable should be considered from the perspective of an independent investor.[57] The question is whether such an investor would be willing to compensate the employee in like fashion. The factors to be considered were the nature and quality of the services and the effect of the services on the investor's return and the corporation's profits.[58]

Under the *Elliots* analysis, the employee's role as shareholder and the nonpayment of dividends are to be viewed as only two of the many factors to be considered in evaluating the reasonableness of compensation. The court recognized the difficulty inherent in distinguishing between dividends and the compensation received by employee-shareholders of a closely held corporation due to the lack of "arms-length" dealing.[59] Because

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55. 716 F.2d at 1243.

56. *See Nor-Cal,* 503 F.2d 359. *See also Klamath Med. Serv. Bureau,* 261 F.2d 842. The Ninth Circuit's approach gives equal weight to all factors which contribute to the reasonableness analysis and completely rejects the automatic dividend rule which examines compensatory intent first and allows the lack of dividends to overrule even a finding of reasonable compensation. Under the court's analysis, any compensation which is found to be reasonable will have its compensatory intent inferred with the exception of "rare" cases where there is evidence of a disguised dividend.

57. 716 F.2d at 1247.

58. *Id.* at 1245.

59. Due to the very nature of close corporations, they seem to attract more than their fair share of litigation. As one commentator explains:

> As a practical matter, the question of deductibility of amounts paid to stockholder-employees only arises in the context of the closely held corporation. There is no statutory authority for a differentiation in tax treatment between the closely-held corporation (with only a few stockholders, in which all or most of the stockholders serve as officers and employees of the corporation) and the publicly-held corporation

the sole shareholder-officer would be the sole recipient of dividends, the observation that compensation is in proportion to ownership interest is meaningless.[60] Other evidence must be present to press the examination beyond that of reasonable compensation and into compensatory intent.

The *Elliots* court examined the question of whether the payments to Elliot were for his role as employee-officer or shareholder.[61] The analysis focused on the reasonableness of compensation payments as a whole under all the factors and circumstances.[62] The court organized the inquiry into five broad

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> (with its stock traded over the counter or on one of the national or regional exchanges). However, salary and bonus payments to stockholder-employees of closely held corporations are said to be subject to special scrutiny because of the lack of an "arms-length" relationship between the employee and his corporate employer. Harolds Club v. Comm'r, 340 F.2d 861 (9th Cir. 1965). In reality, it is reasonable to believe that chief executive officers of a large publicly-held corporation, whose stock is widely distributed among a large number of investors, with no single dominant stockholder or group of stockholders, do not bargain at "arms-length" for their compensation. In such a situation, it is generally recognized that management is in control of the proxy machinery which elects the board of directors, and thus is nominally subservient to the directors so elected.

See A. BERLE AND G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 66-69 (rev. ed. 1967); Walthall, *supra* note 31 at 1 n.1.

60. All payments to a sole shareholder are in proportion to his stockholdings. Therefore, the use of compensation payments which are in proportion to stock ownership as part of the test for hidden dividends would always be indicative of disguised dividends where none had been distributed. Prior to the *Elliots* decision, that factor was used in conjunction with a lack of dividends as an indicator on noncompensatory intent. *See Schneider*, 500 F.2d at 153, and *Pacific Grains*, 399 F.2d at 605-606. The Ninth Circuit's opinion in *Elliots* has removed a troublesome step from the reasonableness analysis.

61. *See* note 29 *supra*. The question in *Elliots* as to whether the payments were for the role of employee-officer or shareholder appears to be another way of asking if the payments were dividends or compensation. The underlying assumption is that if the conclusion reached is that the payments were for the employee role, they must be compensation. The simple converse of this is that if they are not for the employee role, they must therefore be for the shareholder role and thus dividends. The next assumption in this approach is that if the payments were for the employee role but were in excess of a reasonable amount then the excess must be for the shareholder role and thus dividends. This approach avoids the *McCandless* result where payments which are reasonable could be attributed to the shareholder role since it allocates the compensation for the employee role first and the excess to the shareholder.

62. An objective viewpoint is taken in this analysis. This alleviates the scrutiny of subjective intent as a primary focus unless evidence points to a specific intent. Even the assumption that payments in excess of what is reasonable for the employee role should be considered as payments to the shareholder role may be modified in light of some

categories of factors that were to be given equal weight.

The first category was the employee's role in the company.[63] The court noted that the Tax Court's findings that Elliot worked 80 hours per week to be an "appropriate consideration."[64] However, the court questioned the Tax Court's characterization of Elliot's qualifications as a "capable executive" with "no special expertise."[65] After examining the record, the court pointed out that the Tax Court should reconsider Elliot's "extreme personal dedication and devotion to his work" and to what extent an independent investor would be willing to compensate him.[66]

The second category, which the court labeled "external compensation" was the comparison of the employee's salary to salaries paid by similar companies for like services. The court condoned the Tax Court's comparison of Elliot's compensation to that of managers at other John Deere dealers.[67] The compari-

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factors or circumstances such as the economy or the fluctuations of contingent salaries. 716 F.2d at 1246-48.

63. The court relied on American Foundry v. Comm'r, 536 F.2d 289, 291-292 (9th Cir. 1976). The court looked at the position held, the hours worked, the duties performed and the general importance of the employee to the success of the company. 716 F.2d at 1245.

64. 716 F.2d at 1245-46.

65. *Id.* at 1246. Elliot had a degree in Political Science and ran his own company, yet the Tax Court felt there was nothing in the record demonstrating any special expertise. 40 T.C.M.(CCH) at 813.

66. 716 F.2d at 1246. The viewpoint of the independent investor avoids the difficult subjective analysis of the compensatory intent test. A similar analysis was used in Carole Accessories v. Comm'r, 32 T.C.M.(CCH) 285 (1973)(citing Hecht v. United States, 54 F.2d 968 (Ct.Cl. 1932)). The case referred to the "unrelated employer." 32 T.C.M.(CCH) at 1289.

67. The relative size of the concerns being compared should also be taken into consideration. A salary will be found reasonable as long as "[i]t compares favorably with salaries shown to have been paid that year to heads of kindred industrial concerns whose total earnings were much greater." Hoffman Radio Corp. v. Comm'r, 177 F.2d 264, 266 (9th Cir. 1949). When a comparison is made to another company for the purpose of determining reasonableness, it is important to compare the profits and not the gross sales. The Ninth Circuit addressed this point in Wagner and Son, Inc. v. Comm'r, 93 F.2d 816 (1937) when they stated:

> Petitioner introduced no evidence to show the salaries paid by other concerns in similar circumstances. Although petitioner shows the amount of its sales for the years prior to 1929, it does not show the amount of profit for those years. Obviously, a large amount of sales does not alone justify a particular salary, for those sales may have been at a figure below cost.

Id. at 819.

son was made on the basis of the multiple services that Elliot had provided to the company.[68]

The third category involved the character and condition of the company. This focused on the company's size as indicated by its sales, net income and capital value[69] as well as the complexities of the business and the general economic conditions.[70] The court agreed with the Tax Court's consideration of these

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68. Elliot did the work of two or three persons at other John Deere dealers and so the appropriate comparison was to multiple salaries. 716 F.2d at 1246. *See supra* note 5. *See* Treas. Reg. § 1.162-7(b)(3).

69. In General Water Heater Corp. v. Comm'r, 42 F.2d 419 (1930), the Ninth Circuit looked at the ability to pay dividends as negating the inference created by no dividends actually being paid. "It is contended that it was reasonable to pay these salaries because after their payment there was left sufficient income to pay 7.5 per cent. [sic] on the invested capital for the year 1921, and 9.6 per cent. [sic] for the year 1922." *Id.* at 420. Yet the requirement that a certain amount exist for potential distribution as a dividend is not far removed from the requirement that the dividends actually be distributed because the policy still invades the realm that should be reserved as a business decision. The evaluation of the appropriate rate of return on an investment and the timing of withdrawal of profits from a corporation are both business decisions. *See* O'Neill, *supra* note 29, at 84. If the existence of dividends becomes a focus instead of a factor, then not only does the payment of a dividend come into consideration but the amount of the dividend would be open to scrutiny. Widespread use of the doctrine would shift the principal focus of reasonable compensation disputes away from an evaluation of amounts paid and services performed to an examination of the return on equity capital. Instead of evaluating the payments in relation to the work performed by the employees, courts would be evaluating the payments in terms of the return that these employees are entitled to as shareholders. Besides being a further digression from the Code provisions, this would impose an additional burden on the owners of closely held corporations. Investment decisions in a free society are made for a myriad of reasons, and the anticipated and actual return on such investments varies concomitantly. The *McCandless* doctrine penalizes the shareholder investor for any decision which deviate from the norm established by the court. This interference by the judiciary would result in rigidities pertinent to only one business form, thus reducing the value to society of the closely-held corporation. Vondran, *Updating the McCandless Doctrine: Taxing of Reasonable Compensation Paid by Closely-Held Corporations*, 12 J. MAR. L. PRAC. & PROC. 113, 132 (1978).

70. Since the amounts paid under contingent compensation may be calculated based on profits and profits are affected by economic conditions, such fluctuations have been considered by the courts as a relevant factor.

> On the factual side, there is no denying that petitioner's situation had by 1943 changed radically because of the unanticipated advent of the war. The Court found that the unusually large amount of business done that year was attributable in the main, not to services rendered by Hoffman, but to war conditions making for abnormal earnings.

Hoffman, 177 F.2d at 266. Another example of a condition that will affect earnings of a number of industries is a fluctuating market price. "External conditions, specifically the Russian wheat sale, resulted in a high market price for grain during part of the period at issue." M & K Farms, Inc. v. United States, 556 F. Supp. 50, 51 (D. Montana, 1982).

factors and did not engage in any further analysis.[71]

The fourth category focused on factors which indicate conflict of interest.[72] The court reasoned that where a relationship[73] exists between the corporation[74] and the employee which would permit the disguise of dividends as compensation, a close examination of the situation is warranted. The court reiterated that the compensation should be examined from the perspective of the hypothetical independent shareholder who would be concerned with the amount of profits that would be left after the compensation was paid.[75] As long as a reasonable return was

71. 716 F.2d at 1246. The Tax Court considered numerous charts detailing data pertaining to other John Deere dealers but comparison was difficult because the other dealerships serviced different sized territories and only two others sold both agricultural and industrial equipment as Elliots Inc. did. The Tax Court did address the effect of economic conditions:

> Also, we have noted that, compared with other years, all John Deere agricultural dealers in the area in which petitioner operated with sales volume comparable to petitioner's had higher profits than in any other year for which we have statistics, indicating that economic conditions substantially contributed to the profitability of sales of agricultural equipment in that year.

40 T.C.M.(CCH) at 813. The basic assumption is that the officer-employees role contributes to the profitability of the corporation and to his own compensation if it is based on a contingent formula tied to profits. However, if the profits are viewed as a result of a windfall due to economic conditions, the role of the officer-employee is nullified. It seems illogical to attribute the profits to one simple factor or the other. During poor economic times, any profit made may be due to the relative diligence and genius of the employee. On the other hand, during periods of economic growth, a company that does poorly may blame management. The better view would seem to be that profits are affected by numerous economic and personnel factors and the analysis should be conducted on both levels.

72. Under the facts of the *Elliots* case, this part of the court's analysis was critical in undermining the logic behind the *McCandless* rule.

73. One such relationship is where, as in the instant case, the employee is the sole-shareholder. Another very common relationship if familial. "The Board of Directors authorizing the bonuses was comprised of Rodgers, his wife, and an attorney with only the first two participating at the time of authorization." *Pacific Grains*, 399 F.2d at 605. It is in situations like this that the Ninth Circuit's "independent investor" analysis lends an objective viewpoint to a very subjective situation. 716 F.2d at 1245.

74. A closely-held corporation can be defined as "one in which both the management and ownership are to a substantial degree vested in a small group of persons, and in which there is a high frequency of overlapping of the roles of shareholder, director, and officer by these persons or members of their immediate families." Vondran, *supra* note 69, at 116.

75. The assumption is that an "independent investor" would be flexible in approach to each situation but would want to protect investments in a reasonable fashion. Compensation schemes which leave no profits may lead to an inference of a disguised dividend if an "independent investor" would object under the circumstances. An example of

available to the investor, the court concluded that it is a good indicator that the compensation is not a disguised dividend. The court stated that the corporation's 20% rate of return indicated that the corporation and Elliot were not exploiting their relationship.[76]

The court looked at one more set of factors in determining whether the payments were attributable to Elliot's role as an employee or as a shareholder. The fifth category looked at inconsistencies in the corporation's payments to employees. The court reasoned that existence of a "reasonable, longstanding, consistently applied compensation plan" is evidence of reasonable compensation.[77] In the instant case, the annual bonus was paid according to a predetermined formula of fifty-percent of net profits over a period of twenty years.[78] The court stressed that the reasonableness of contingent payments is to be based on the reasonableness of the formula itself.[79]

The court stated that the Tax Court erred by concentrating

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such a plan is found in Sunset Scavenger Co. v. Comm'r, 84 F.2d 453 (9th Cir. 1936): "Petitioner also contends that there was a mutual agreement contract (implied perhaps) between the members and petitioner whereby the members were to receive all the net profits; that because of such agreement there could be no moneys belonging to petitioner, and therefore petitioner would have no profits." *Id.* at 455. An independent investor might not find this to be a reasonable way to nurture an investment.

76. The Tax Court had limited its findings to the connection between the sole shareholder and the lack of dividends. The Ninth Circuit characterized these findings as relevant factors but pointed out that those two factors can't be used in isolation and that any such situation requires further examination. 716 F.2d at 1246-47.

77. *Id.* at 1247-48. "Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered." Treas. Reg. § 1.162-9 T.D. 6500, 1983-15 C.B. 658.

78. It should be noted that the bonuses were not paid exclusively to Elliot. "All of the employees of petitioner participated to some extent in these bonuses, the amount being determined by a vote of the board of directors and not by a present [sic] formula as was the case of the bonus to Mr. Elliot." 40 T.C.M.(CCH) at 805. That the bonuses were not made exclusively to officer-shareholders negates one of the factors the Ninth Circuit considered in *Nor-Cal* to determine that the compensation was not purely for services. 503 F.2d at 362. *See supra* note 19.

79. 716 F.2d at 1248. In Schanchrist Foods, Inc. v. Comm'r, 77 T.C.M.(P-H) 559 (1977), the Tax Court found that the formula used was a good faith attempt to arrive at a reasonable level of compensation. The base salary was $30,000 and 4% of invested capital retained for future growth. The first $10,000 net profits yielded 50%, the next $10,000 yielded 40%, the third $10,000, 30% and 10% of the remaining profits were added in. *Id.* at 563-64.

on the *amounts* paid under the formula for the two years in question and not on the reasonableness of the formula.[80] The formula in the instant case had over-compensated in some years and undercompensated in others yet the court felt such fluctuations should not make the formula unreasonable[81] if it has been reasonable in the long run.[82] The court directed that the viewpoint should be that of an independent investor who would look for a formula which allowed a satisfactory return on equity over the long run.[83]

80. 716 F.2d at 1248.

81. As one commentator put it, "[t]he reasonable salary test need not be met on an annual basis but only over the whole period of employment." Ford and Page, *Reasonable Compensation: Continuous Controversy*, 5 J. Corp. Tax'n 307, 315 (1979).

82. A comparison of the compensation actually paid to Elliot with that stated to reasonable by the Tax Court shows the actual average compensation to be less than the figure determined by the Tax Court to be a reasonable average annual income.

Fiscal Year Ending February 28	Consumer Price Index (1967=100.0)	Compensation Paid Mr. Elliot	Reasonable Compensation Under Tax Court Decision	Difference
1968	100.00[3]	$ 42,800	$ 81,246	$ (38,446)
1969	104.2	19,600	84,658	(65,058 [sic]
1970	109.8	34,035	89,208	(55,173)
1971	116.3	84,450	94,489	(10,039)
1972	121.3	68,323	98,551	(30,228)
1973	125.3	66,401	101,801	(35,400)
1974	133.1	136,536	108,138	28,398
1975	147.7	181,074	120,000	61,074
1976	161.2	193,663[sic]	130,968[4]	62,695
1977	170.5	153,696	138,524	15,172
1978	185.0	83,052	150,305	(67,253)
Total		$1,063,630	$1,197,888	$(134,258)
Average		$ 96,694	$ 108,899	$(12,205)[5]

[3] The Consumer Price Index for the calendar year ending immediately prior to the end of the respective fiscal year is used because the fiscal year ends only two months after the close of the calendar year.

[4] The increase in compensation determined by the Tax Court for the year ending February, 1975 was less than the increase in the Consumer Price Index.

[5] The comparison would not be significantly different if the amount of $125,000 for the year ending February 28, 1976 was used as the base. Using the 1976 figure, the annual average for Reasonable Compensation Under Tax Court Decision would be $103,936 or $7,205 more than the average compensation paid to Mr. Elliot.

Brief for Appellant at 7, *Elliots*, 40 T.C.M.(CCH) 802. The chart utilizes $120,000 for the fiscal year ending February 28, 1975 as determined by the Tax Court to be reasonable compensation. The figures represent what would have been reasonable under the Tax Court decision with adjustment for changes in the Consumer Price Index. *Id.*

83. 716 F.2d at 1248.

A formula, according to the court, should compensate for the work done, the performance achieved, the responsibility assumed and the experience and dedication of the employee.[84] The court noted that any implication on the part of the Tax Court that incentive payment plans for shareholder-employees are unreasonable was erroneous.[85] The court expressed approval of such plans and their tendency to encourage extra effort and dedication which in turn contributes to the overall success of the corporation.[86] The court stressed that the mere fact that an employee is also a shareholder does not make the plan unreasonable as long as an independent investor would approve.[87]

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84. *Id.*

85. *Id.* The Tax Court had relied on the *Schneider* case for the rejection of incentive-bonus plans. The *Schneider* court focused on the lack of arms-length bargaining which it considered to be precluded by the fact that the employee was the sole shareholder. "No special incentive was necessary to insure his best efforts for he would receive the fruits of success through his status as the majority shareholder. . . ." 40 T.C.M.(CCH) at 811 (quoting *Schneider,* 500 F.2d at 153). The Tax Court, in *Elliots,* rejected the significance of a longstanding formula to determine the compensation of a sole shareholder and quoted *Schneider. Schneider* is distinguishable from *Elliots* due to the nature of the agreements. Two percent of the net sales were set aside for taxes and then the net profits were equally divided by the officer-shareholders. This system never left any amount to be paid as a dividend and thereby precluded any payment of dividends. Although no dividends were paid, the *Elliots* formula allowed the payment of dividends, if desired, since the bonus only incorporated 50% of the net profits. *But see supra* note 72.

86. *Id.*

87. *Id.* The court's conclusion is supported by the language of Treas. Reg. § 1.162-7(b)(2):

> The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain made before the services are rendered, not influenced by any other consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

Treas. Reg. § 1.162-7(b)(2). The application of this part of the statute becomes especially significant when there is a sole shareholder such as Elliot involved. The statute approves the use of contingent compensation but cautions that it should be "pursuant to a free bargain." This causes difficulty in a closely-held corporation since it is inherently difficult to prove that the agreement was reached on objective grounds. The Ninth Circuit's use of the "independent investor" becomes critical in reaching the threshold determination of whether the method of fixing compensation and the resulting formula (in contin-

IV. CRITIQUE

In holding that no conclusive presumption of a disguised dividend arises from the bare fact that a profitable corporation does not pay dividends, the Ninth Circuit followed the tenor of Treasury Regulation section 1.162-7. The regulation states that "the compensation may not exceed what is reasonable under all the circumstances."[88] The court decided correctly that no one factor is decisive in the determination of reasonableness.[89]

Apparently the Internal Revenue Service recognized the same reasoning in 1979 when they re-evaluated automatic indicators of disguised dividends.[90] Revenue Ruling 79-8 backed away from the application of an automatic dividend rule in an employee-shareholder lack of dividend situation, but characterized the lack of dividends as a "very significant factor."[91] However, the ruling disallows a lack of dividends as the sole ground for rejection of a deduction if the compensation is otherwise reasonable and is paid for services actually rendered.[92]

Despite the language of the Treasury Regulations, Revenue Ruling 79-8 and case law which emphasizes the factual nature[93] of the reasonable compensation inquiry, the government attempted to utilize *McCandless*-type reasoning in both their Tax Court and Ninth Circuit arguments in *Elliots*.[94] The Ninth Circuit's unequivocal rejection of *McCandless* should return the analysis of reasonable compensation back to that of "reasonable-

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gent compensation situations) was reasonable.

88. Treas. Reg. § 1.162.7(b)(3). *See supra* note 16.

89. 716 F.2d at 1248.

90. Rev. Rul. 79-8 C.B. 92.

91. *Id.* at 93.

92. *Id.*

93. *See supra* note 21.

94. *See supra* note 35. This approach diverges from the weighing of facts and inferences prescribed by the *Mayson* and *Irby* cases. *See supra* note 21. Most alarming is the attempted use of the 15% figure as an automatic calculation. The corporation in *McCandless* was in the business of ceramic tile contracting and the years questioned were 1963-65. Elliots Inc. was in the business of selling and servicing John Deere equipment and was questioned regarding the years of 1975 and 1976. The 15% figure in *McCandless* has been criticized because the basis for it was never articulated by the court. There was no justification for choosing that particular percentage and it would seem unwise to promote its future arbitrary application. It was probably this attempt to lift the percentage out of the factual context of *McCandless* and apply it automatically to the *Elliots* facts which prompted the Ninth Circuit to clarify this matter once and for all by rejecting the automatic dividend rule.

ness" and should ease the job of tax planners, at least in the Ninth Circuit.[95] The loss of "lack of dividends" as a trigger for disguised dividends will no doubt have an effect upon the scrutiny given the tax returns of sole shareholder-employees by the Internal Revenue Service.[96]

The decision to reject *McCandless* was primarily based on the fact that no statute requires dividends to be paid by profitable corporations.[97] The court noted that the accumulated earnings tax[98] was intended to handle such abuses. This blanket statement only clouds the issue instead of clarifying it.

It is true that the accumulated earnings tax comes into effect when a corporation allows profits to accumulate beyond its reasonable needs. However, the inference that has created the specific problem addressed in *Elliots* is not based on abuse due to profits being allowed to *accumulate*. The inference is that profits are not being paid as dividends nor accumulated because they are being siphoned-off via the mechanism of disguised dividends in compensation. The problem is one of under-accumulation. The accumulated earnings tax cannot handle this abuse because there will be no accumulation to trigger its provisions.

The focus should be on what is a reasonable amount of profit for a corporation to retain, not on how the profits which are not retained are utilized. Profits can be visualized on a spectrum, with a reasonable amount of profit retention in the middle

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95. *See* Walthall, *supra* note 31 at 1.

96. *Id.* at 3.

> [O]nly a small minority of professional decisions concerning the deductibility of compensation and the adequacy for tax purposes of dividend distributions are made by courts in litigated cases. The majority of such decisions are made, in the first instance, by lawyers and accountants consulting with their clients in the business planning process. Even when the Internal Revenue Service disputes the propriety of a portion of the compensation payments or the adequacy of dividends, the issues, in the overwhelming majority of cases, are settled by negotiation. The decided cases, numerous as they may be, reveal only the tip of the iceberg.

Id. at 3 n.6.

97. 716 F.2d at 1244. The rejection was also based on the fact that no law precluded the reinvestment of dividends and that such activity may be in the best interest of the corporation.

98. *See supra* note 49.

and over-accumulation and under-accumulation on each end. Accumulated earnings are statutorily penalized once they surpass a certain dollar amount on the profit spectrum. The statute qualifies the demarcation between reasonable retention and over-accumulation by allowing accumulations beyond a certain dollar amount only if they are being held to meet the corporation's "reasonable needs." Therefore, the over-accumulation end of the spectrum is ultimately limited by an analysis of the purpose for which the profits are being accumulated.

The confusion seems to center around the under-accumulation end of the profit spectrum. There is no statute to set a minimum dollar amount for retained earnings nor is there a qualification that less than that amount can be retained if there are "reasonable needs." The focus is usually on how much profit needs to be retained to insure viability and stability of the corporation.[99] There is an inference that if less than this amount is retained, the security of the corporation may be jeopardized.[100]

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99. United States v. Byrum, 408 U.S. 125, 140 (1972), *reh'g denied* 409 U.S. 898 (1972).

> Even where there are corporate earnings, the legal power to declare dividends is vested solely in the corporate board. In making decisions with respect to dividends, the board must consider a number of factors. It must balance the expectation of stockholders to reasonable dividends when earned against corporate needs for retention of earnings. The first responsibility of the board is to safeguard corporate financial viability for the long term. This means, among other things, the retention of sufficient earnings to assure adequate working capital as well as resources for retirement of debt, for replacement and modernization of plant and equipment, and for growth and expansion. The nature of a corporation's business, as well as the policies and long-range plans of management, are also relevant to dividend payment decisions.

408 U.S. at 140.

100. In *Byrum*, the court stated:

> The spectrum of types of corporate businesses, and of permissible policies with respect to the retention of earnings, is broad indeed. It ranges from the public utility with relatively assured and stable income to the new and speculative corporation engaged in a cylical business or organized to exploit a new patent or unproved technology. Some corporations pay no dividends at all, as they are organized merely to hold static assets for prolonged periods (e.g., land, mineral resources, and the like). Corporations which emphasize growth tend to lower dividend payments, whereas mature corporations may pursue generous dividend policies.

Id.

To go below this level would require the qualification of "good sound business reasons."[101]

It can be reasoned, by analogy, that just as profits in excess of those retained for "reasonable needs" can trigger the accumulated earnings tax, profits below the amount required for "good sound business reasons" should trigger the label of "siphoned-off profits." This approach focuses on the relative amounts retained and the purpose for retention. The spectrum between "siphoned-off profits" and accumulated profits is a matter of degree.

Dividends are specific amounts of profit which are not retained. If a distribution of profits to shareholders is not made, dividends should not be visualized as hovering within the accumulated profits, waiting to be distributed. If they are not declared, they do not exist.[102] A lack of dividends cannot trigger the concept of "siphoned-off profits" because that mechanism is based on an insufficient retention of profits and if a dividend is not declared it does not reduce the degree of profits retained.

However, compensation does reduce the degree of profits retained. By analogy, the reduction in retained profits can be justified by "good sound business reasons" as long as the compensation meets the statutory requirements of section 162.[103] If the amount is found to be unreasonable, it is not justified by "good sound business reasons" and triggers the label of "siphoned-off profits." Accordingly, a disguised dividend is profit that, instead of being distributed as a dividend, which could qualify as a "good sound business reason," is "siphoned-off" under a com-

101. Capitol Markets, Ltd. v. United States, 207 F. Supp. 376, 381 (D. Hawaii 1962). The court stated that "there were good sound business reasons for this [funds retained for expansion of the business], including the necessity to make payments on mortgages and obligations of the company incurred in connection with new investments, and the investment of earnings during a period of community growth justifying such action." *Id.*

102. The exception to this would be when evidence indicates that the compensation in its entirety was not paid for services rendered. Then the dividends can be visualized as "hovering" within the compensation as disguised dividend. Notice, however, that this approach still does not search for the hidden dividend within the accumulated profits and therefore avoids the idea that dividends are mandatory and that if none are distributed, they must be hidden somewhere. The assumption is that if they are hidden, it is in the compensation. However, a second assumption should be that if they are hidden in the compensation, they are only hidden in the part that is in excess of "reasonable."

103. I.R.C. § 162(a)(1) (West 1978). *See supra* note 15.

pensation label. This false labeling of the dividend as compensation, in order to gain tax advantages, is the evil which should be avoided, not the lack of profits distributed as dividends.

The court cited *Casey v. Commissioner* and *Laure v. Commissioner*[104] to support its conclusion that the lack of statutory authority is an indication that Congress purposely avoided requiring dividends to be distributed. Additionally, the court notes that there is no law precluding the reinvestment of corporate profits.[105]

The third justification for the rejection of *McCandless* was that retention and reinvestment may be in the best interest of the corporation. The court relied on *United States v. Byrum* which noted the limited access of close corporations to capital markets.[106] The court's acknowledgment of the special economic

104. 716 F.2d at 1244. Casey v. Comm'r, 267 F.2d 26 (2d Cir. 1959); Laure v. Comm'r, 70 T.C. 1087 (1978). Neither case was Ninth Circuit precedent. The Second Circuit stated:

> We think that the 1954 enactments indicate that Congress did not want the taxing authorities to be second-guessing the responsible managers of corporations as to what extent profits should be distributed or retained, unless the taxing authorities were in a position to prove that their position was correct.

267 F.2d at 30. The Tax Court in *Laure* stated that they "doubt that section 162(a)(1) was intended to permit the Commissioner or the courts to sit in judgment over whether dividends should be paid in lieu of reasonable compensation to employee-shareholders." 70 T.C. at 1098.

105. 716 F.2d at 1244. However, as noted previously, the court recognized that although the retention of profits is not precluded, it may be limited by the accumulated earnings tax. I.R.C. § 531-37 (West 1978). The court's viewpoint reflected the reasoning of the following passage which was cited in the opinion:

> The automatic dividend rule, as well as being unsupported by legal analysis, rests on inadequate economic analysis. The court's perception of the requirement of a return to shareholders is unsatisfactory because it fails to assess adequately the following factors: (1) the concept of the return to a shareholder should not be limited to current dividend payout, but should include the potential of future return or appreciation; (2) the shareholder employee expects a return for services as well as a return to capital, and will seek to maximize the *total* return; and (3) if a corporation is not unprofitable in the sense that it fails to generate a sufficient return for both the shareholder and employee functions, it does not follow that the shareholder's function should be fully compensated, thus allocating the "short-fall" entirely to employee function.

Note, *supra* note 31, at 450 (cited 716 F.2d at 1244).

106. 408 U.S. 125. The Supreme Court reasoned that "directors of a closely held

character of close corporations parallels the trend of greater flexibility in corporation statutes designed to promote close corporations. Such changes are reflected in the Model Business Corporation Act and corporation statutes of a growing number of states.[107] The close corporation, although traditionally handled under the same statutes as publicly held corporations, has different economic characteristics which are often met by special arrangements in the usual corporate model. By analogy, federal tax policy should be responsive to the economic nature of the close corporation.[108]

In *Elliots,* the Ninth Circuit sought to establish clear, predictable guidelines in the area of employee/sole shareholder compensation by utilizing the "independent investor" test.[109] In this area where employee and shareholder roles overlap, it is understandable that there might be motivation for compensation and dividends to overlap. The court's approach eliminates analysis of the actual motive or intent of the party by evaluating the transaction according to the viewpoint of the "independent investor."

The major difficulty in this area is the lack of the arms-length bargaining prescribed by section 1.162-7(b)(2) of the Treasury Regulations.[110] Although the problem is most obvious in a close corporation, it must be recognized that the paradigm arms-length transaction is difficult to find even in publicly held

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small corporation must bear in mind the relatively limited access of such an enterprise to capital markets. This may require a more conservative policy with respect to dividends than would be expected of an established corporation with securities listed on national exchanges." *Id.* at 140.

107. *See Model Business Corp. Act* § 35 (1982). *See also* Cal. Corp. Code §§ 158, 202(a) and 300.

108. A definition of close corporations which reflects the economics of this entity is found in Donahue v. Rodd Electrotype Co. of New England, 367 Mass. 578 (1975).

> There is no single, generally accepted definition. Some commentators emphasize "an integration of ownership and management," . . . in which the stockholders occupy most management positions. Others focus on the number of stockholders and the nature of the market for the stock. In this view, close corporations have few stockholders; there is little market for corporate stock.

Id. at 585.

109. This term was suggested in Note, *supra* note 31, at 450.

110. *See supra* note 87.

corporations.[111] The Ninth Circuit's use of the "independent investor" provides a test that will eliminate the subjective analysis unless the evidence indicates otherwise.[112]

The policy rationale behind an objective approach is important to close corporations because sole shareholder's transactions are never strictly arms-length in nature. This approach recognizes that the "American dream," made up of small business persons who are the epitome of free enterprise, would be undermined at its very foundation if the essential relationship of sole shareholder-employee is characterized as a negative factor.[113]

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111. The officers are on the board of directors which votes for the salaries. *See supra* note 59.

112. *See supra* note 60.

113. In order to determine the appropriate policies for governing corporate entities, the question, "what is the typical corporation?" must be answered. During the years in question in *Elliots,* the typical corporation was not a multi-billion dollar, multi-million shareholder enterprise:

> The number of active corporations in 1976 has been estimated to be 2,105,000. Statistical Abstract of the United States 563 (1979). In terms of dollar assets . . . over 90 percent of U.S. corporations had assets of under a million, or stated another way, the proportion of corporate millionaires to the total number of corporations was less than one in ten. Breaking this down even further, the biggest block of corporations have assets between $10,000 and $1,000,000 and the median corporation has assets of slightly under $100,000. A. CONRAD, CORPORATIONS IN PERSPECTIVE 100, 101 (1976). Thus it would appear that in terms of size, corporations are spread along an unbroken spectrum, with the greatest concentration in numbers at the lower end.
>
> It is also apparent . . . that though corporations with assets of over ten million make up about 1.3 percent of the total number of corporations, they also control 87 percent of the total assets.
>
> Another important consideration is the number of investors. Though there is less information with regard to this than other aspects of corporate size, the available data on shareholders appear to fit the general pattern of corporate statistics. In 1971, General Motors, which ranked first in sales, had about 1,360,000 shareholders; Standard Oil of New Jersey, ranked second, had 808,000. But over 90 percent of the total corporations have ten or fewer shareholders, 1 percent have more than one hundred, and fewer than one hundred corporations have more than one thousand. CONRAD, *supra* at 119.
>
> In summary, it is evident that since the greatest concentration of numbers is found in corporations with assets between $10,000 and $1,000,000 and with less than ten shareholders, if there were such a thing as the typical American corporation, it would certainly not be the corporate giant.

The better view is to encourage such relationships and examine them from the perspective of the "independent investor."

The most revolutionary aspect of the court's opinion involved analyzing the contingent compensation formula as the test for reasonableness. This approach is supported by Treasury Regulation section 1.162-7(b)(2) which states that contingent compensation should be allowed, if made pursuant to a free bargain, despite the fact that "in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid." The court uses the term "formula" to address the concept of the original contract between the employer and employee. The court's common sense approach recognizes that such a contingent compensation formula motivates employees to work harder. It also enables the court to dispel the myth that a shareholder-employee will not be motivated by a bonus because he will benefit whether he applies his best effort or not.

The court concluded that a reasonable, longstanding, consistently applied compensation plan is evidence of reasonable compensation.[114] This approach takes the reasonableness focus away from the amount paid which may fluctuate from year to year under a contingent plan.

Obviously, such fluctuation in amount from year to year is an inherent element of contingent compensation.[115] If evidence of inconsistent compensation is the traditional test for unreasonableness, contingent compensation is suspect by reason of its very design.[116] Although this might not be viewed as a problem

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L. Solomon, R. Stevenson, Jr., D. Schwartz, Corporations, Law and Policy, Materials and Problems 7-8 (1982).

114. 716 F.2d at 1247. The court stated that inconsistency of past compensation is a factor that could be indicative of the payments going "beyond reasonable." *Id.* Although the court cited no authority for this proposition, such a perspective has been forwarded by both the Seventh Circuit and the Tax Court. Six years was seen as a long enough period to aid in establishing reasonableness in *Edwins*, 501 F.2d 675. *See* Madison Silo Co. v. Comm'r, 11 T.C.M.(CCH) 82, 86 (1952); Osborne Motors v. Comm'r, 35 T.C.M.(CCH) 691, 693 (1976).

115. "If the principal of bonus compensation is to be recognized, it carries with it the payment of liberal compensation in good years and moderate compensation in lean years." Roth Office Equipment Co. v. Gallagher, 172 F.2d 452, 456 (6th Cir. 1949).

116. Rapid increases in compensation should be avoided absent strong

> proof that there has been a corresponding increase in the duties and responsibilities of the executives. The natural tendency of the IRS is to regard the earlier compensation ar-

if the perspective is taken that there is always the alternative of noncontingent compensation, this viewpoint ignores the policy reasons behind contingent compensation which is to "encourage and compensate extra effort and dedication which can be valuable to a corporation."[117] There is truth to the argument that contingent compensation can provide a vehicle for "siphoning-off" profits but such an intent can readily be discovered by objectively examining the formula in relation to the character and financial condition of the corporation.

An individual who accepts a contingent compensation plan may do so out of an interest in seeing the young corporation succeed. A sole shareholder-employee may exhibit a willingness to put off individual reward presently in order to further the corporate stability.[118] This view is especially persuasive in the context of a small corporation that is just getting started.

The court stressed that because the formula might overcompensate in some years and undercompensate in others, the determination of reasonableness should be made with a view of the long term results.[119] This approach will benefit companies which have been in existence for a substantial period of time because their average compensation over time can be identified and examined in order to mitigate the tax consequences of a few high years.

A young corporation that initially overcompensates may be penalized in the present despite the fact that the formula may prove to provide less than adequate compensation in the long run. A possible consideration in such a circumstance would be to resort to a comparison of the formulas used by like companies, for like positions. Such a comparison would yield an idea of the average results under such a formula and show whether it is reasonable within the industry.

The court stated that a formula that was reasonable over a

> rangements as establishing the standard of reasonableness for the position in question.

Walthall, *supra* note 31 at 24.

117. 716 F.2d at 1248.

118. *See* James J. McHale Co. v. United States, 151 F. Supp. 115 (N.D. Ohio 1957).

119. 716 F.2d at 1248.

long period of time should not be deemed unreasonable solely because it overcompensates for one or two years.[120] This reasoning may plague the Internal Revenue Service as it attempts to show overcompensation in cases where only one or two years are being examined. Taxpayers with a short corporate history will argue that given the benefit of an average extended over, for example, ten years, the compensation would be reasonable.

This argument is not new in the sense that it has been presented in cases where the taxpayer has argued that excessive compensation was for undercompensated past services.[121] The difficulty here is in timing because the reasonableness of the contingent compensation is tied into its long term average which is dependent upon when in the cycle of the corporation the IRS issues its notice of deficiency. In a general sense, the reasonableness of any one amount for any one year is never completely determined until the end of the employee-corporation relationship. From a more pragmatic viewpoint, the comparison of formulas used by like corporations over the same years will be fairly helpful. The major problem is finding a corporation which the court will accept as being "like" the one in issue.[122]

The court pointed out that changed circumstances may make a previously reasonable formula unreasonable. Conversely, it would seem plausible for further changes in circumstances to make the formula reasonable again. This part of the opinion will be susceptible to abuse by both the taxpayer and the IRS. The taxpayer will argue that the formula which the IRS labels as unreasonable might turn out to be reasonable given a few more years. The IRS will argue that the circumstances have changed and the fact that the formula was reasonable at inception is now

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120. *Id.*

121. "The statute [Treas. Reg. § 1.162-7] does not require that the services should be actually rendered during the taxable year, but that the payments therefore shall be proper expenses paid or incurred during the taxable year." Lucas v. Ox Fibre Brush Co., 281 U.S. 115, 119 (1930).

122. [T]he courts very narrowly define "like" when considering comparative data. For comparative data to be acceptable, the courts generally seem to require that the company be of the same size and complexity, and that the number of management personnel as well as the scope of management responsibility be the same.

Hoffman, *Heeding Significant Factors Improves Odds for Reasonable Compensation,* 50 J. TAX'N 150, 153 (1979).

irrelevant.

Again the timing will be the critical element because the court has expanded the issue of reasonableness of annual compensation into the "lifetime" of the corporation-employee relationship. The much needed support that the opinion lends to the area of contingent compensation insures this form of compensation a contuing role in motivating independent business persons to take on the risks associated with ownership of a close corporation. However, the lack of guidelines for determining the relevant time period in which the contingent compensation should be scrutinized may make it difficult for new corporations to take advantage of this approach.

New corporations would seem to be the most reasonable candidates for contingent compensation and are most in need of the benefits of the long term averaging. The court's recommendation of the use of the "independent investor" may prove helpful in the analysis of compensation for small corporations with a short history. As long as a reasonable return on equity is available, the lack of long term averages may not be a hindrance.

V. CONCLUSION

In *Elliots* the Ninth Circuit reached sound conclusions. However, the opinion does not address the issues surrounding the applicable time period for determining the reasonableness of compensation. The result bolsters the use of contingent compensation but refocuses the controversy to the reasonableness of the formula. The analysis, however, is still factual in nature and the sole shareholder is well advised to keep accurate records and document activities related to compensation. Most importantly, the formula should be reviewed from time to time to insure that the compensation paid under it is reasonable not only for the individual year but for the "lifetime" of the corporation-employee relationship.

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