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In this report, Morrison and Howlett consider the application of the reasonable compensation standard to the section 199A deduction, highlighting issues that are likely to arise under the Tax Cuts and Jobs Act.

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I. Introduction

The complexity of new section 199A, which President Trump signed into law as part of the 2017 tax reform (informally known as the Tax Cuts and Jobs Act), has taken on a celebrity of its own.[1] Broadly speaking, section 199A provides individuals and some trusts[2] a deduction equal to 20 percent of their qualified business income (QBI) derived from a qualified trade or business (QTB) that the individual either operates directly or owns through a relevant passthrough entity (RPE) such as an S corporation or partnership. To address the complexities and ambiguities in section 199A, Treasury and the IRS have issued 247 pages and more than 70,000 words of regulations to complement the less than 5,000 words actually in section 199A.[3] While the regulations address many questions inherent in the statutory text, they say little about one of the most significant limitations on the new deduction: reasonable compensation.

"Reasonable compensation" is an idea that keeps reappearing in federal tax law. Given the enormous dollar amounts at play regarding the section 199A deduction,[4] it is worth revisiting that history. This report summarizes section 199A and the regulations Treasury and the IRS have issued thereunder, as well as the development of the reasonable compensation standard in (pre-section-199A) common law. The report also highlights issues likely to arise as the reasonable compensation standard is applied to the section 199A deduction.

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[1] *See, e.g.*, Christopher W. Hesse, "The Section 199A Deduction Is Not 'That Simple,'" *Tax Notes*, Sept. 10, 2018, p. 1595.

[2] For simplicity, this report ignores the rules applicable to non-grantor trusts. It also ignores the applicability of section 199A to cooperatives, publicly traded partnerships, and real estate investment trusts. The rules applicable to individual owners are complicated enough.

[3] Word count and page number for the final regulations are taken from RIN 1545-B071 (Jan. 18, 2019) and include Treasury and the IRS's preamble. With minor corrections, the final regulations were published in the *Federal Register* on February 8. T.D. 9847, 84 F.R. 2952.

[4] In 2012, passthrough businesses earned $1.63 trillion in net income, compared with $1.1 trillion for C corporations. Scott Greenberg, "Pass-Through Businesses: Data and Policy," The Tax Foundation (Jan. 17, 2017). The Joint Committee on Taxation estimated that section 199A would reduce revenue by $414.5 billion through 2027 (the provision expires for tax years beginning after December 31, 2025). JCT, "Estimated Budget Effect on the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,'" JCX-67-17 (Dec. 18, 2017).

II. Section 199A and the Final Regulations

A. Section 199A

Section 199A provides individuals with an income tax deduction equal to 20 percent of their QBI from each QTB they either operate directly (including through a limited liability company disregarded as separate from the taxpayer for federal income tax purposes) or through an RPE.[5] The deduction is limited to 20 percent of the taxpayer's taxable income less the taxpayer's net capital gain for the year.[6] For taxpayers with taxable income exceeding $415,000 ($207,500 in the case of nonmarried taxpayers), the deduction is limited to the greater of (1) 50 percent of the taxpayer's allocable share of the QTB's Form W-2 wages or (2) the sum of 25 percent of the taxpayer's allocable share of the QTB's Form W-2 wages and 2.5 percent of the taxpayer's allocable share of the unadjusted bases of all qualified property of the QTB (generally, depreciable property used in the QTB for the production of QBI).[7]

A QTB is any trade or business (determined under section 162 principles)[8] other than a specified service trade or business (SSTB) or the trade or business of performing services as an employee.[9] For taxpayers with a taxable income exceeding $415,000 ($207,500 in the case of nonmarried taxpayers), an SSTB is any trade or business that (1) involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business in which the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners; or (2) involves the performance of services that consist of investing or investment management, trading, or dealing in securities, partnership interests, or commodities.[10]

QBI generally means the net amount of qualified items of income, gain, deduction, and loss regarding any qualified trade or business of the taxpayer.[11] Such an item will generally be "qualified" if it is (1) effectively connected with the conduct of a trade or business within the United States under the principles of section 864(c) and (2) included or allowed in determining taxable income.[12] There are several exceptions to this general rule, including "non-ordinary" items (for example, capital gains and losses, dividends and equivalents, subpart F income, and so on).[13]

Also, section 199A(c)(4) provides rules for the "treatment of reasonable compensation and guaranteed payments" regarding QBI. That provision provides that QBI does not include:

(A) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered regarding the trade or business;

(B) any guaranteed payment described in section 707(c) paid to a partner for services rendered regarding the trade or business; and

(C) to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered regarding the trade or business.

It is the section 199(c)(4)(A) provision that this article discusses.

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[5] Section 199A(a)(1), (b)(2). Section 199A also provides deductions for certain REIT dividends, publicly traded partnership income, and income attributable to the domestic production activities of specified agricultural or horticultural cooperatives. These aspects of section 199A are outside the scope of this report.

[6] Section 199A(a)(2). The term "taxable income" as used in this report and section 199A refers to taxable income computed without regard to any deduction allowed under section 199A. Section 199A(e)(1).

[7] Section 199A(b)(2), (4), (6). This limitation is phased in for taxpayers with taxable incomes between $315,000 and $415,000 ($157,500 and $207,500 in the case of nonmarried taxpayers) and does not apply to taxpayers with taxable incomes below these amounts. Section 199A(b)(3).

[8] Whether a trade or business exists for section 199A purposes is a factual determination guided by long-standing case law under section 162, and not all profit-seeking activities will rise to the level of being a trade or business. *See* preamble to final section 199A regulations, T.D. 9847, 84 F.R. at 2954.

[9] Section 199A(d).

[10] Section 199A(d)(2). The limitation described in (1) is phased in for taxpayers with taxable income between $315,000 and $415,000 ($157,500 and $207,500 in the case of nonmarried taxpayers) and does not apply to taxpayers with taxable income below these amounts. Section 199A(d)(3).

[11] Section 199A(c)(1).

[12] Section 199A(c)(3).

[13] Section 199A(c)(3)(B).

B. Regulations Under Section 199A

Even before Trump signed the TCJA, commentators were concerned about the scope of the "reasonable compensation" limit articulated in section 199A(c)(4)(A). A common concern was whether the "reasonable compensation" limit would apply to *all* passthrough entities or only to S corporations.[14] The lack of a modifier in section 199A(c)(4) suggested that the reasonable compensation limit would apply to all passthrough entities, and Treasury and the IRS may have considered this approach.[15]

The concern was important. As the tax community articulated, imposing "reasonable compensation" limits on partnership income would raise significant issues.[16] For example, if the reasonable compensation standards were applied to partnerships, for the first time partnerships would have to consider how that standard interacts with the already complicated rules for transactions between a partner and a partnership in a nonpartner capacity (section 707(a)) and guaranteed payments (section 707(c)). Finally, and maybe most significantly, applying the idea of reasonable compensation to a partner in a partnership would disturb the long-standing principle that a partner cannot be an employee of the partnership.[17]

Providing some relief for anxious tax attorneys and return preparers, Treasury indicated early on that it viewed the application of the "reasonable compensation" limit in section 199A narrowly. Then-Treasury Deputy Assistant Secretary for Tax Policy Dana L. Trier stated on February 9, 2018, that "that reference [in section 199A(c)(4)(A)] to reasonable compensation is not an indication to redo the law of reasonable compensation."[18] Trier added, however, that section 199A(c)(4) was "written as it's written," and that Treasury could issue guidance applying the reasonable compensation standard beyond S corporations.[19]

Ultimately, and perhaps in response to taxpayer comments as well as to a statement in the legislative history of section 199A that referenced only S corporations regarding the reasonable compensation rule,[20] the regulations that Treasury and the IRS proposed in August 2018[21] limited the scope of section 199A(c)(4)(A) to S corporations. Specifically, prop. reg. section 1.199A(b)(2)(ii)(H) provides that "reasonable compensation *received by a shareholder from an S corporation*" is not included in QBI (emphasis added). Treasury and the IRS explained the addition of this limiting language in the preamble:

> The Treasury Department and the IRS have received requests for guidance on whether the phrase "reasonable compensation" within the meaning of section 199A extends beyond the context of S corporations for purposes of section 199A. The Treasury Department and the IRS believe "reasonable compensation" is best read as limited to the context from which it derives: Compensation of S corporation shareholders-employees. If

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[14] *See, e.g.*, Donald B. Susswein, "Understanding the New Passthrough Rules," *Tax Notes*, Jan. 22, 2018, p. 497 ("The IRS might also consider early guidance clarifying that sole proprietors and partners are not required to provide or designate any amount of their net business income as reasonable compensation for services that may be provided to the enterprise in exchange for all or a portion of its net income.").

[15] *See* Matthew R. Madara, "Passthrough Deduction Intended to Benefit Middle Class," *Tax Notes*, Jan. 29, 2018, p. 588 (quoting Audrey Ellis, attorney-adviser for the Treasury Office of Tax Legislative Counsel as stating that "we have to think about how [the reasonable compensation] rule would apply in other contexts.").

[16] *See, e.g.*, New York State Bar Association Tax Section, "Report No. 1392 on Section 199A Deduction," at 28-29 (Mar. 23, 2018) ("We believe that use of the term 'reasonable compensation' in Section 199A(c)(4) was clearly intended as a means of incorporating the long-standing statutory and regulatory authorities that have for many decades applied solely in the corporate context. . . . The absence of any explicit suggestion [to the contrary] strongly implies that Congress intended no such deviation, and accordingly we believe that if any portion of a partner's distributive share or a sole proprietor's items of income were intended to be treated as 'reasonable compensation,' a legislative amendment may be required."). *Cf.* Reuven S. Avi-Yonah et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the House and Senate Tax Bills* 28 (Dec. 7, 2017) ("Arguably, the 'reasonable compensation' standard could be applied more broadly — and, if this were true, this loophole would be largely closed — but this would likely require regulatory action by the IRS (with only weeks remaining before the new legislation is likely to take effect) and the IRS action could be subject to challenge in court. If Congress does not intend for this massive loophole in the Senate's pass-through provision, it must address this directly.").

[17] *See* Rev. Rul. 69-184, 1969-1 C.B. 256.

[18] Madara, "No Plans to Apply Reasonable Compensation Beyond S Corps," *Tax Notes*, Feb. 19, 2018, p. 1123.

[19] *Id*.

[20] H.R. Rep. No. 115-446, at 215 (Dec. 15, 2017) (Conf. Rep.) ("Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer.").

[21] *See* REG-107892-18, 83 F.R. 40884 (Aug. 16, 2018).

> reasonable compensation were to apply outside of the context of S corporations, a partnership could be required to apply the concept of reasonable compensation to its partners, regardless of whether amounts paid to partners were guaranteed. Such a result would violate the principle set forth in Rev. Rul. 69-184, 1969-1 CB 256, that a partner of a partnership cannot be an employee of that partnership. There is no indication that Congress intended to change this long-standing Federal income tax principle.

Thus, despite the broad language of the statute, the proposed regulations reaffirmed the long-standing principle that the reasonable compensation standard applied only to S corporations and their shareholders. The final section 199A regulations, which Treasury and the IRS issued January 18, 2018,[22] were identical to the proposed regulations regarding the reasonable compensation rule.[23] In the preamble to the final regulations, Treasury and the IRS rejected comments requesting various changes to the reasonable compensation rule.[24] They likewise rejected a request to provide additional guidance for what constitutes reasonable compensation, stating that doing so is "beyond the scope of these final regulations."

But what is the standard? And what challenges are likely to arise applying this standard to the section 199A deduction?

III. The Reasonable Compensation Standard

A. History of the Standard

Reasonable compensation cases date back to at least 1949[25] and generally arise in one of two contexts. First, shareholder-employees of closely held C corporations historically have been able to lower their overall taxes by characterizing payments from the corporation as compensation, which are deductible to the C corporation, rather than as dividends, which are not deductible to the corporation and subject to an individual dividends received tax.[26] Second, and conversely, shareholder-employees of S corporations have been able to lower their payroll taxes by characterizing payments from the corporation as dividends rather than compensation.[27] Taxpayers generally do not pay self-employment tax on dividends received from an S corporation,[28] whereas they do pay self-employment tax on amounts received from an S corporation that are in substance compensation for employment received.[29]

In both contexts, the ability to manipulate the character of payments typically depends on the degree to which the employees are also owners of the corporation. Thus, when a corporation is owned by its employees, the employee-owners often will seek to characterize payments to themselves in the way that most effectively reduces their overall tax burden.

The IRS has challenged those characterizations under section 162(a)(1), which allows the corporation a deduction for "a *reasonable* allowance for salaries or other

[22] *See* T.D. 9847.

[23] Reg. section 1.199A-5(b)(2)(ii)(H).

[24] T.D. 9847, 84 F.R. at 2964.

[25] *See, e.g., Mayson Manufacturing Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949).

[26] Dividends received by an individual from a domestic C corporation are ordinary income but may be subject to the same preferential rate as long-term capital gains (either 0, 15, or 20 percent depending on the taxpayer's income). *See* section 1(h)(11). Combined with a corporate rate of 21 percent and the 3.8 percent section 1411 net investment income tax, dividends received from a domestic C corporation are subject to a maximum tax rate of 1 x (1 - 21 percent) x (1 - 20 percent) x (1 - 3.8 percent) or 39.8 percent. The maximum individual rate following the TCJA is 37 percent. Hence, for individual taxpayers subject to the highest marginal rates there remains an incentive to characterize payments from C corporations as compensation rather than dividends.

[27] *See, e.g., Watson v. United States*, 668 F.3d 1008, 1018 (8th Cir. 2012).

[28] Rev. Rul. 59-221, 1959-1 C.B. 225.

[29] Section 3111; Rev. Rul. 74-44, 1974-1 C.B. 287.

compensation for personal services actually rendered."[30] The IRS may challenge either that the compensation is too much, likely in the context of a C corporation, or too little, likely in the context of an S corporation. Either way, thanks to these planning opportunities and the IRS's attempt to restrain them, there is voluminous and well-developed precedent on what is "reasonable compensation,"[31] albeit with some significant variation between courts.[32]

B. Section 162 Regulation

Treasury promulgated a regulation regarding the section 162 deduction for "reasonable compensation" in 1958, which remains in effect today.[33] Reg. section 1.162-7 bisects section 162's "reasonable compensation for personal services actually rendered" language into two prongs: First, compensation payments must be reasonable; and second, compensation must be in fact payments for services rendered.[34] In other words, compensation must be reasonable to be deductible, and it must be actually intended as compensation for services. This second "intent" prong is not the focus of this report, but it's worth noting that relatively few cases that have been resolved on the issue.[35] As one court explained, "proof of the second prong, which requires a 'compensatory purpose,' can be difficult to establish because of its subjective nature."[36] Thus, most section 162 cases turn on whether compensation is reasonable.

On that point, the regulation defines reasonable compensation as "such amount as would ordinarily be paid for like services by like enterprises under like circumstances,"[37] and it provides factors to consider in determining whether compensation is reasonable. For example, the regulation states that the mischaracterization of payments as either dividends or compensation is "likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries."[38]

While the regulation certainly should not be ignored, courts have treated it (if at all) as a general principle that, along with other factors, indicates whether compensation is deductible.[39] Many courts refer to it only in passing,[40] and one court has even said that the definition of reasonable compensation provided by the regulation "is not an operational standard."[41] Thus, to understand "reasonable compensation," we must turn to the case law.

C. The 'Reasonable' Case Law

The circuit courts are divided on what the appropriate test for "reasonableness" should be, and that divide has only grown in recent years. We can group the approaches into three general buckets. First, several circuits use a multifactor approach.[42] Second, the Ninth and Second circuits use a multifactor approach but through the perspective of an independent investor.[43] Finally, the Seventh Circuit has replaced the multifactor approach with an independent-investor analysis.[44] We next look at each method before considering their implications on section 199A.

[30] Emphasis added. To the extent courts refer to the regulations at all, they generally treat them as general principles that, along with other factors, indicate whether compensation is deductible. *See, e.g.*, *Menard v. Commissioner*, 560 F.3d 620, 622 (7th Cir. 2009) ("courts have tried to operationalize the Treasury's standard by considering multiple factors that relate to optimal compensation").

[31] The authors have reviewed 67 cases, most of which came from the Tax Court.

[32] *Compare Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, 680 F.3d 867 (7th Cir. 2012) (applying an "independent investor" test to determine reasonable compensation), *with Elliotts Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983) (applying a multifactor test).

[33] T.D. 6291.

[34] Reg. section 1.162-7(a).

[35] *See, e.g.*, *Neonatology Associates PA v. Commissioner*, 115 T.C. 43, 46 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002) (noting that "nothing in the record illustrates that taxpayers diverted these corporate assets with the requisite 'compensatory intent'").

[36] *Elliotts*, 716 F.2d at 1243.

[37] Reg. section 1.162-7(b)(3).

[38] Reg. section 1.162-7(b)(1).

[39] *See, e.g.*, *Owensby & Kritikos Inc. v. Commissioner*, 819 F.2d 1315, 1324 (5th Cir. 1987). Similar in the Seventh Circuit, which has abandoned the multifactor approach, the regulations seem to have little bearing. *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 838 (7th Cir. 1999).

[40] *Mulcahy*, 680 F.3d at 868.

[41] *Menard*, 560 F.3d at 623.

[42] *See, e.g.*, *Mayson*, 178 F.2d 115; *see also Owensby*, 819 F.3d at 1327 (the Fifth Circuit found that the independent investor test should be considered as an additional factor).

[43] *See, e.g.*, *Dexsil Corp. v. Commissioner*, 147 F.3d 96 (2d Cir. 1998); *Elliotts*, 716 F.2d 1241.

[44] *See Menard*, 500 F.3d at 622-623.

1. The multifactor approach.

Most courts use a multifactor approach, but the number of factors varies significantly.[45] In dismissing the multifactor approach as unworkable, Judge Richard Posner claimed that the Tax Court has used as many as 21 different factors.[46] Of course, those factors are often related. As the First Circuit observed in *Haffner's*, "other circuits and the Tax Court have used multi-factor tests, the factors ranging from a handful to almost two dozen in various formulations [but] by and large, longer lists include elements that, in shorter ones, are grouped together."[47] Accordingly, rather than run the entire daunting gauntlet of all the factors in this report, we discuss the Ninth Circuit's five factors, which group together many of the factors used by various courts.[48]

The Ninth Circuit's five general factors are: (1) the shareholder-employee's role in the company; (2) a comparison with similar employees in similar companies; (3) the character and condition of the company; (4) the existence (or lack thereof) of a conflict of interest between the ownership and employees of a corporation; and (5) any internal consistency in the payment of compensation and dividends.[49] No single factor is decisive, and there is no clear weighting of the significance of the factors.[50]

a. Employee's role in the company.

The first factor to determine whether compensation is reasonable is the shareholder-employees' role in and contribution to the success of the company, which includes the duties performed, the hours worked, and other relevant metrics of the employees' contribution to the enterprise. In *Ginger Masonry*, for example, the Tax Court found that the shareholder-employee's compensation was reasonable because he "was a highly motivated employee working as much as 15.5 hours a day" and that "despite his lack of formal business training" the shareholder-employee "acquired the skills necessary to manage every facet" of the corporation's business.[51] By contrast, the First Circuit in *Haffner's*, found that the ministerial roles two shareholders occupied "undermine[d] the support for very high bonuses."[52]

One way to evaluate a shareholder-employee's contribution is to see if the employee is performing multiple roles. The court in *Ginger Masonry* took note that the shareholder-employee "handled all . . . executive and managerial duties," and concluded that the shareholder-employee's compensation "should reflect the combined salaries of the job positions he performed," which included "the roles of chief executive officer, chief financial officer, chief operations/administrative officer, and marketing executive."[53] Similarly, the Second Circuit in *Dexsil* instructed the Tax Court, on remand, to consider the many roles the shareholder-employee performed in determining reasonable compensation.[54] But a shareholder-employee may go too far in stating his role in the corporation. In *LabelGraphics*, for example, the Tax Court found it "questionable" that the shareholder-employee "performed the work of four full-time executives," and consequently gave the taxpayer's dubious claim on that issue little weight.[55]

A court may find compensation unreasonable even when the employee is entirely responsible for the corporation's income. The Tax Court reached this conclusion in *Palmer*.[56] There, the shareholder-employee defended his compensation by reasoning that if he were not so well paid, he would quit. Because the

[45] *See, e.g.*, *Mayson*, 178 F.2d 115; *see also* Lawrence R. Duther, "The Independent Investor Test: The Latest Test in the Search for Reasonable Compensation Is Blurred in the Second Circuit," 45 *Wayne L. Rev*. 1953, 1958 n.26 (Winter 2000).

[46] As noted by Posner in *Exacto Spring*, 196 F.3d at 834, the Tax Court in *Foos v. Commissioner*, T.C. Memo. 1981-61, identified "the astonishing total of 21 factors."

[47] *Haffner's Service Stations v. Commissioner*, 326 F.3d 1, 3 (1st Cir. 2003).

[48] *Multi-Pak Corp. v. Commissioner*, T.C. Memo. 2010-139 (citing *Elliotts*, 716 F.2d at 1245).

[49] *Id.*

[50] *Elliotts*, 716 F.2d at 1245.

[51] *John L. Ginger Masonry Inc. v. Commissioner*, T.C. Memo. 1997-251. *But see LabelGraphics Inc. v. Commissioner*, 221 F.3d 1091, 1098 (9th Cir. 2000) (concluding that the Tax Court did not err in finding that though the employee may have performed "some of the duties of and functions of four . . . executives, he did not perform work equal to the full-time services of four such executives").

[52] *Haffner's*, 326 F.3d at 5.

[53] *Ginger Masonry*, T.C. Memo. 1997-251.

[54] *Dexsil*, 147 F.3d at 103.

[55] *LabelGraphics*, T.C. Memo. 1998-343, *aff'd*, 221 F.3d at 1098.

[56] *Donald Palmer Co. v. Commissioner*, T.C. Memo. 1995-65, *aff'd without opinion*, 84 F.3d 431 (5th Cir. 1996).

corporation's earnings depended entirely on his services, he argued that a third-party owner would find his compensation just.[57] The Tax Court rejected this argument, stating that there are "limits to reasonable compensation . . . even for the most valuable employees."[58]

b. External comparison.

The second factor is a comparison of the compensation of the employee with the compensation paid by other companies for similar services. That comparison is supported by the definition of "reasonable compensation" in reg. section 1.162-7(b)(3), which says that it is generally "just to assume that reasonable and true compensation is only such amounts as would ordinarily be paid for like services by like enterprises under like circumstances."

This inquiry into the compensation of comparable employees at comparable companies often involves expert testimony or reference to publicly available data. In *Multi-Pak*, for example, the taxpayer's expert witness compared the total compensation of the employee with that of similar employees in publicly traded companies (adjusted for size). Although the employee's compensation fell at the very top end of that scale, the expert concluded it was nevertheless within a range that would be considered reasonable.[59]

Some courts have been willing to allow a taxpayer to take a higher compensation than her peers when the taxpayer can show that her business outperformed similar companies. The Tax Court in *Menard*, for example, found that the taxpayer's relatively high compensation was reasonable, at least to a degree, because his company had a higher rate of return on equity than its competitors,[60] but the Tax Court still limited his compensation to what it believed was warranted by the company's higher rate of return.[61]

c. Character and condition of the company.

Courts also consider the general economic condition of the taxpayer's company as indicative of the shareholder-employee's "effect on the company."[62] This includes the character and condition of the company, such as its size, net income, capital value, the complexities of the business, and the level of debt carried by the corporation.[63]

The condition of the company can be a contentious issue. In *Miller & Sons*, the parties disagreed whether the character and condition of a small drywall business favored the taxpayer.[64] The IRS argued that because the business was small and its "business model was not interested in growth," high compensation was not reasonable. The taxpayer, by contrast, claimed that because sales were constant, compensation was justified. Making its own analysis, the Tax Court considered that "although the drywall business did not require highly technical knowledge . . . the shareholder-employees developed the skills and methods to accurately bid on and complete projects within budget." Further, the Tax Court noted that the taxpayer had been in the drywall business for over 20 years and that several "competitors emerged and failed" during that time. Ultimately the court concluded that the character and condition of the corporation favored the taxpayer.[65]

Just because a business is large or complex, however, does not mean that a court will find its

[57] *Palmer*, T.C. Memo. 1995-65.

[58] *Id. See also Richlands Medical Association*, T.C. Memo. 1990-660 (finding it "inappropriate to determine 'reasonable compensation' for one individual performing multiple roles by aggregating the salaries of multiple persons performing one of those roles on a full-time basis").

[59] *Multi-Pak*, T.C. Memo. 2010-139 ("Professor Murphy concluded that the payments Mr. Unthank received in 2002 and 2003 are within a range of reasonable compensation. He stated that although Mr. Unthank was highly paid, there was nothing inappropriate or unreasonable per se in paying an executive in the 95th percentile of total compensation on a size-adjusted basis."). *See also Ginger Masonry*, T.C. Memo. 1997-251 (evaluating expert testimony from the taxpayer and the IRS on the external comparisons).

[60] *Menard*, T.C. Memo. 2005-3, *rev'd*, 560 F.3d 620.

[61] *Id.* On appeal, the Seventh Circuit rejected the Tax Court's rate of return formula as overly simplistic. 560 F.3d at 627 (calling the Tax Court's approach an "arbitrary as well as dizzying adjustment" and reversing the Tax Court's decision that a portion of the executive's compensation was not reasonable).

[62] *Id.*

[63] *See, e.g., K & K Veterinary Supply v. Commissioner*, T.C. Memo. 2013-84; *Thousand Oaks Residential Care Home v. Commissioner*, T.C. Memo. 2013-10.

[64] *Miller & Sons Drywall Inc. v. Commissioner*, T.C. Memo. 2005-114.

[65] *Id.* This contributed to the Tax Court's ultimate finding that a "preponderance of the evidence show[ed] that petitioner's shareholder-employees were reasonably compensated for each year in issue." *Id.* at 1289.

character and condition supports the taxpayer's compensation. In *Aries Communications*, for example, the Tax Court found that a large telecommunications corporation's condition did not support the taxpayer's compensation because the corporation had "a negative net income and a bleak financial picture."[66]

In gauging the success of a corporation, courts will also consider general economic conditions. In *Alpha Medical*, for example, a medical management company pointed out that its gross receipts and net income had increased while the number of licensed home healthcare providers declined in the same region.[67] The Sixth Circuit, following the Tax Court, found this analysis unpersuasive, noting that the number of home healthcare providers licensed in the region was not the same as the number of dollars being spent on healthcare.[68] Because it was possible that more money was being spent on fewer home healthcare providers, the Tax Court determined that the evidence did not show "the industry suffered from adverse economic conditions."[69]

d. Conflicts of interest.

Courts consider whether "some relationship exists between the taxpaying company and its employee which might permit the company to disguise nondeductible corporate distributions."[70] This is true of corporations when all the shareholders are members of the same family.[71] But it is also true whenever "officers who control the corporation set their own compensation."[72] As noted by the Fifth Circuit in *Owensby*, when "the corporation's shareholders are its key employees, it is in the interest of all parties to characterize amounts distributed to the shareholder-employees as compensation rather than dividends."[73] The inquiry "is whether some relationship exists between the company and the employees which might permit the former to disguise nondeductible corporate distributions of income as salary expenditures"[74] or, in the case of S corporations, disguise salary expenditures subject to FICA taxes as distributions. In some sense, this will be the case whenever the employee is also a shareholder, but the degree will vary significantly. A relevant consideration is to what extent the employee can set her own compensation (that is, is the employee-shareholder also a manager of the corporation). As will be discussed later, once a court has established that there is a conflict of interest, the court may use the independent investor test to gauge whether that conflict has had any effect on the employee's compensation.[75]

e. Internal consistency.

Courts consider the internal consistency of compensation. As discussed in more detail below, this inquiry is multifaceted. A court may inquire into whether compensation (1) varies between shareholders based on ownership interest,[76] (2) is consistent between shareholders and nonshareholder employees,[77] and (3) is consistent over time.[78]

i. Correlation between stock ownership and compensation.

Any relationship between the compensation paid to employee-shareholders and stock

[66] *Aries Communications Inc. v. Commissioner*, T.C. Memo. 2013-97. This contributed to the Tax Court's ultimate conclusion that the shareholder-employee's compensation was not reasonable for the year at issue. *Id.* at 1596.

[67] *Alpha Medical v. Commissioner*, 172 F.3d 942, 948-949 (6th Cir. 1999).

[68] *Id.*

[69] *Id.* at 949.

[70] *Elliotts*, 716 F.2d at 1247.

[71] *See, e.g.*, *McClung Hospital Inc. v. Commissioner*, T.C. Memo. 1960-86 (considering the importance of the familial relationship between those in charge of the corporation and the shareholder-employees, but ultimately finding that the compensation paid was reasonable). *McClung Hospital* is one of the earliest cases that applies the reasonableness requirement to a professional service corporation. *See also* Edward M. Alvarez, "The Deductibility of Reasonable Compensation in the Close Corporation," 11 *Santa Clara L. Rev.* 20, 34 (1970).

[72] *Multi-Pak*, T.C. Memo. 2010-139.

[73] *Owensby*, 819 F.2d at 1322-1323.

[74] *Ginger Masonry*, T.C. Memo. 1997-251.

[75] *See, e.g.*, *LabelGraphics*, 221 F.3d at 1099.

[76] *See, e.g.*, *Ginger Masonry*, T.C. Memo. 1997-251 ("Internal inconsistency in petitioner's treatment of payments to employees may indicate that the payments to Ginger were not reasonable. . . . Bonuses that have not been awarded under a formal and consistently applied program are suspect.").

[77] *See Haffner's*, 326 F.3d at 4.

[78] *Owensby*, 819 F.2d at 1325.

ownership may indicate that the compensation is in part a distribution of earnings. Reg. section 1.162-7(b)(1) states that if "excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock." Following this logic, the Fifth Circuit in *Owensby* stated that "the correlation between stockholdings and payments makes it necessary for the court to consider whether payments are disguised dividends even if the shareholder-employees contributed services in proportion to their stockholdings."[79]

But the Tax Court has rejected the opposite conclusion, that a lack of correlation between payments and stockholdings is evidence that compensation is reasonable. The taxpayer in *Mulcahy* argued that "because the amounts it reported as compensation for each minority shareholder were more than the amounts it reported as compensation for each founder," the compensation at issue "must have been reasonable."[80] The court noted that the payments received by minority shareholders "could have been partially composed of profit distributions" because the taxpayer did not establish that the payments "were actually compensation for services."

ii. Shareholder-employees and non-shareholder employees.

Courts consider whether shareholder-employees are compensated similarly to non-shareholder employees. In *Haffner's*, for example, the First Circuit noted that except for the shareholder-employees, "no one else in the company received significant bonuses."[81] This difference in compensation between employees did "not help the taxpayer and at worst hurt its position." The Second Circuit in *Dexsil* similarly noted that although the taxpayer distributed bonuses "to each of its employees . . . shareholder-employees received bonuses that were considerably larger than non-shareholder employees."[82]

iii. Compensation over time.

Courts consider whether a shareholder-employee's compensation has fluctuated over time.[83] An aberration, such as one year in which the taxpayer's compensation dramatically jumps, may indicate that the compensation is unreasonable. In *LabelGraphics*, for example, the Fifth Circuit noted that the year in issue was "truly off the charts."[84] Courts do allow for a taxpayer to "make-up" compensation for services performed in earlier years,[85] but look closely at the circumstances surrounding the change in compensation. In *Haffner's*, the First Circuit rejected the argument that an increase in an employee's compensation was to make-up for prior services, noting that "such make-ups can be more convincingly defended as market-based where performance is improving and retention of a key executive [is] a matter of forward-looking concern." Similarly in *LabelGraphics*, the court found the "make-up" argument unconvincing without more proof than conclusory statements.[86]

A court may consider compensation unreasonable if it has increased over time while the company's performance has not improved.[87]

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[79] *Owensby*, 819 F.2d at 1324. *Cf. Brinks Gilson & Lione v. Commissioner*, T.C. Memo. 2016-20, in which the shareholder's stock interest was based on the shareholder's expected compensation. In that case, the Tax Court upheld the Service's imposition of substantial understatement penalties under section 6662(a) and (b)(2) on the grounds there was no substantial authority or other defense for treating payments to the shareholder as compensation rather than a distribution.

[80] *Mulcahy*, T.C. Memo. 2011-74, *aff'd*, 680 F.3d 867.

[81] *Haffner's*, 326 F.3d at 4.

[82] *Dexsil*, 147 F.3d at 99.

[83] *See, e.g.*, *Ginger Masonry*, T.C. Memo. 1997-251 ("Ginger knew that petitioner would need strong financial statements and considerable equity in order to work with the large developers. To this end, Ginger received less compensation in years prior to the years in issue. Petitioner, as a result, retained a significant portion of its earnings and increased its equity base.").

[84] *LabelGraphics*, 221 F.3d at 1096.

[85] *Id.* at 1096-1097; *see also Haffner's*, 326 F.3d at 5.

[86] *LabelGraphics*, 221 F.3d at 1096.

[87] *See Haffner's*, 326 F.3d at 5.

Inversely, some courts have taken the view that compensation tied to the company's performance may be unreasonable because shareholder-employees already benefit from the company's success as shareholders.[88] As stated by the Tenth Circuit, a "bonus contract that might be reasonable if executed with an executive who is not a controlling shareholder may be viewed as unreasonable if made with a controlling shareholder, since incentive to the stockholder to call forth his best effort would not be needed."[89]

When compensation fluctuates with the performance of the business, the use of a set formula for compensation over a long period of time may be evidence that compensation is reasonable. Courts recognize that a formula which is established when the business is started or when future earnings are questionable may "overcompensate in good years and undercompensate in bad years,"[90] and that compensation which is reasonable over a long period of time should not be deemed unreasonable based on one or two years standing in isolation.[91] Such a formula does not need to be formal or in writing,[92] but whether a formula is evidence that compensation is reasonable may depend on when the formula was set up and whether the formula has been consistently followed.[93] And even a long-standing and consistently applied formula might result in unreasonable compensation payments if the formula itself is unreasonable.[94]

While the multifactor approach has an intuitive appeal, the approach will not provide much assurance for many taxpayers. Ambiguity regarding the relative weight of the factors, challenges inherent in evaluating the factors, and the sheer breadth of factors make it difficult to advise whether any given taxpayer's compensation is reasonable. Recognizing this, some circuits have adopted a more rigid model.

2. The independent investor test.

a. Overview.

The independent investor test asks whether, after compensation is paid to shareholder-employees, the remaining profit in the business provides a rate of return on equity that would satisfy an independent investor. As described by the Second Circuit, "if the bulk of the corporation's earnings are being paid out in the form of compensation, such that the corporate profits do not represent a reasonable return on the shareholder's investment, then an independent investor would probably disapprove of the compensation arrangement."[95] The independent investor standard can be phrased inversely as asking whether "an inactive, independent investor would be willing to compensate the employee as he was compensated."[96] The circuit courts that have adopted the independent investor test have taken three different approaches.

First, some circuits have added an independent investor analysis as "simply one of the factors a court should consider."[97] In other words, some circuits treat the independent investor inquiry as having relatively equal importance to the other facts that are part of the multifactor analysis. The Eighth Circuit arguably followed this approach in *Charles Schneider*, finding that the taxpayer's compensation was unreasonable because the corporation had "immense success in the industry" but had never paid dividends or provided any other return of investment to shareholders.[98] Adding any independent investor analysis to a multifactor

[88] *See, e.g.*, *Pepsi-Cola Bottling Co. of Salina v. Commissioner*, 528 F.2d 176, 182 (10th Cir. 1975).

[89] *Id.*

[90] *Dexsil*, 147 F.3d at 101-102 (quoting *Elliotts*, 716 F.2d at 1248).

[91] *Id.* at 102.

[92] *Id.* at 101.

[93] *Id.* at 101-102 (quoting *Kennedy v. Commissioner*, 671 F.2d 167, 175 (6th Cir. 1982)) (stating that "a formula will be upheld 'if it was set up when the business started, or when the amount of future earnings was questionable, and has been consistently followed through the ups and downs of the business'").

[94] *Elliotts*, 716 F.2d at 1247 ("Whether payments under such a formula are reasonable will depend on whether the formula is reasonable," and even a formula that reasonably compensates "should not stand in the way of a satisfactory return on equity.").

[95] *Dexsil*, 147 F.3d at 101.

[96] *Elliotts*, 716 F.2d at 1245.

[97] *Owensby*, 819 F.2d at 1327; *see also K & K Veterinary Supply*, T.C. Memo. 2013-84 (considering rate of return on equity as one of 10 factors).

[98] *Charles Schneider & Co. v. Commissioner*, 500 F.2d 148, 153 (8th Cir. 1974). The Tenth Circuit decided not to adopt the independent-investor test in *Eberl's Claim Service v. Commissioner*, 249 F.3d 994, 1003 (10th Cir. 2001). But the Tax Court has interpreted the Tenth Circuit's approach as being a multifactor approach with the independent investor inquiry as an additional factor. *B&D Foundations v. Commissioner*, T.C. Memo. 2001-262.

approach does not necessarily give taxpayer's more certainty. In *Owensby*, for example, the court found that compensation was unreasonable even though the corporation had provided a rate of return on equity to its shareholders "far in excess of the return on equity of most comparable, publicly traded corporations."[99]

Alternatively, the Second and Ninth circuits have treated the independent investor analysis as the perspective or lens through which all other factors should be viewed.[100] As the Second Circuit stated in *Dexsil*, "the independent investor test is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed."[101] Because the Tax Court in *Dexsil* failed to even mention the independent investor test "or the specific considerations that courts have held to comprise the independent investor test," the Second Circuit remanded that case to the Tax Court for reconsideration.[102] Following *Elliotts*, the Ninth Circuit uses the five categories previously discussed while keeping in mind that "it is helpful to consider the matter from the perspective of a hypothetical independent investor."[103] In practice, and as recognized by the Tax Court,[104] the Ninth Circuit's approach is the same as the Second Circuit.

The Seventh Circuit, led by Posner, has adopted a third, and more extreme, view of the centrality of the independent investor test.[105] Under this approach, if the taxpayer can show that an independent investor of the corporation would be satisfied with the rate of return on equity for the years at issue, the burden shifts to the IRS to show compensation is unreasonable.[106] In *Exacto Spring*, for example, the Seventh Circuit overturned a Tax Court decision that a shareholder-employee's compensation was unreasonable because the appellate court found that an independent investor "would be *overjoyed*" with the rate of return for the years at issue.[107] The Seventh Circuit is the only circuit to go this far — the Fifth Circuit explicitly rejected a similar approach in *Owensby*.[108] In any event, it's not clear how the "overjoyed investor" approach would apply in the context of an S corporation, when shareholder-employees are motivated to keep compensation as low as possible to reduce FICA taxes and, beginning in 2018, to maximize their section 199A deduction.

This presumption in favor of the taxpayer can be rebutted when the corporation's success is not clearly attributable to the taxpayer's efforts. Posner provides an example of a corporation that unexpectedly discovers oil under its land.[109] In that situation, the corporation's rate of return might be very high and yet compensation is still unreasonable because the corporation's financial success is not attributable to the efforts of the shareholder-employee.

b. A satisfying return.

How much should an independent investor expect as a return on her equity? Whether the rate of return is realized through stock appreciation or dividends,[110] identifying the appropriate rate of return raises several issues.[111] First, the court must determine whether capital is a material income-producing factor for the corporation. Second, when capital is a material income-producing factor, the court must determine how to measure the equity of the corporation. Finally, the court must determine what the appropriate rate of return should be on that equity. Generally, this is

[99] *Owensby*, 819 F.2d at 1333-1334.

[100] *Dexsil*, 147 F.3d at 101.

[101] *Id.* at 100-101.

[102] *Id.* at 101.

[103] *See, e.g.*, *LabelGraphics*, 221 F.3d at 1095.

[104] *See Haffner's*, T.C. Memo. 2002-38 (describing the approach followed by the Second and Ninth Circuits as the same), *aff'd*, 326 F.3d at 1.

[105] *Mulcahy*, 680 F.3d at 867.

[106] *Id.* at 871. Otherwise, the "the Commissioner's determination of reasonableness carries a presumption of correctness." *See, e.g.*, *Owensby*, 819 F.2d at 1324; *Dexsil*, 147 F.3d at 100. *See also Midwest Eye Center v. Commissioner*, T.C. Memo. 2015-53 (explaining the operation of the independent investor test in the Seventh Circuit as shifting the presumption of correctness from the IRS to the taxpayer).

[107] *Exacto Spring*, 196 F.3d at 838-839 (emphasis in original).

[108] *Owensby*, 819 F.2d at 1327 ("We do not agree, however, with the taxpayers' interpretation of this statement as creating a 'substantial presumption.' The so-called independent investor test is simply one of the factors a court should consider, and in certain cases it may be a substantial factor.").

[109] *Menard*, 560 F.3d at 623.

[110] *Id.* at 1326.

[111] Courts also disagree whether the appropriate comparison is the return on equity for a single year or over a period of time. *See, e.g.*, *B&D Foundations*, T.C. Memo. 2001-262 (noting that different circuit courts have used different measures for the return on equity).

established by the rate of return of comparable businesses.

i. Material income-producing factor.

The first issue is how to treat corporations, such as small professional service corporations, for which the "only significant input is the services rendered by its owner-employees,"[112] or when capital is not a material income-producing factor.[113] A shareholder of a firm when capital is not a material income-producing factor cannot expect much, if any, return. As noted by Posner, in a small professional service corporation with only a few employees, the corporation's income "isn't meaningfully distinct from its employee-owners; their income from the rendition of personal services is almost identical to the firm's income."[114] In such a situation, Posner considers the legal entity of the corporation to be a "pane of glass" between the professional and his billings.[115]

Arguably, based on current and prior regulations involving other areas of the code, capital is *never* a material income-producing factor for a professional service corporation. Regulations relating to a partner's distributive share of income under section 704, for example, state that, "in general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership."[116] Similarly, current regulations defining foreign earned income for purposes of section 911 instruct taxpayers that professional fees should be treated as earned income rather than a distribution of earnings.[117] In defining earned income for section 1348, which Congress repealed in 1981, reg. section 1.1348-3(a)(3)(ii) stated that "whether capital is a material income-producing factor must be determined by reference to all the facts of each case," but:

> In general, capital is not a material income-producing factor where gross income of the business consists principally of fees, commissions, or other compensation for personal services performed by an individual. Thus, the practice of his profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which he conducts his practice since his capital investment is regarded as only incidental to his professional practice.[118]

And former reg. section 1.1361-2,[119] which involved a since-repealed precursor to the current section 1361,[120] provided that "an enterprise engaged in rendering professional services such as law, accounting, medicine, or engineering,

[112] *Mulcahy*, 680 F.3d at 871.

[113] *See Owensby*, 819 F.2d at 1317-1319, 1325 (finding that "capital was not a material income-producing factor" for an engineering firm providing its services to oil companies); *see also Hubbard-Ragsdale v. Commissioner*, 15 F.2d 410, 411 (S.D. Ohio 1926) (finding "where the intrinsic nature of the business is the rendition of a 'service' to another, as in the case of real estate brokers, lawyers, doctors, or even artisans, who need not supply materials, the use of capital is merely incidental").

[114] *Mulcahy*, 680 F.3d at 871.

[115] *Id.*

[116] Reg. section 1.704-1(e)(1)(iv).

[117] Reg. section 1.911-3(b)(1) defines "earned income" as "amounts received as compensation for personal services actually rendered . . . [and not] any portion of an amount paid by a corporation which represents a distribution of earnings and profits." Reg. section 1.911-3(b)(3) provides explicitly that "earned income includes all fees received by an individual engaged in a professional occupation (such as doctor or lawyer) . . . even though the individual employs assistants to perform part or all of the services, provided the patients or clients are those of the individual and look to the individual as the person responsible for the services rendered."

[118] *See* Economic Recovery Tax Act of 1981, P.L. 97-34, section 101(c)(1) (codified as amended in scattered sections of the IRC) (repealing section 1348). Former section 1348 provided for a maximum tax rate of 50 percent on the "earned income" of an individual, estate, or trust. At the time, maximum marginal tax rates applicable to those types of tax rates were higher.

[119] Reg. section 1.1361-2 (1966) (as amended by T.D. 6496, and before removal by T.D. 8104).

[120] Former section 1361 permitted an unincorporated business to be taxed as a domestic corporation, but only if the enterprise was "one in which capital is a material income producing factor." Internal Revenue Code of 1954, P.L. 83-591, section 1361; repealed by the Act of April 14, 1966, P.L. 89-389, section 4. The Committee Report from the Senate Finance Committee for the Internal Revenue Code of 1954 notes that because the election "is limited to those businesses where capital is a material income-producing factor," it would not apply to "firms engaged in professional services such as the law, accounting, medicine, engineering, and others." S. Rep. No. 83-1622, at 119 (1954).

ordinarily is not an enterprise in which capital is a material income-producing factor." Under this old section 1361, an unincorporated entity could elect to be taxed as a corporation, but only if it was an entity in which capital was a material income-producing factor.

The Tax Court in *Brinks* rejected the argument that any of these other current and former provisions of the code establish that capital is never a material income-producing factor in a professional service corporation. The Tax Court dismissed these authorities as deserving "little or no weight" because none of them "address deductibility of compensation paid to shareholder employees."[121] In a footnote, the Tax Court conceded that the section 911 regulations may treat some amounts of income attributable to invested capital as part of professional service fees. But, the court rejoined, "the possibility that, in some contexts, the law foregoes an effort to determine the portion of an attorney's professional service income attributable to capital does not justify treating as deductible compensation payments made by a corporate law firm to shareholder attorneys that eliminate its book income and leave no return to the shareholders on material amounts of invested capital."

Instead, the Seventh Circuit and the Tax Court approach is that while capital may not be a material income-producing factor for a small professional service corporation, the "pane of glass" concept does not extend to larger professional service corporations. In *Mulcahy*, the Seventh Circuit rejected the idea that the income of a large accounting firm was not at least in part attributable to the capital of the firm. The court noted that the firm had "physical assets to support some 40 employees in multiple branches, and . . . intangible capital in the form of client lists and brand equity."[122] Because the firm's treatment of payments to employee-shareholders "reduced the firm's income to zero, and thus the return to the equity investors, to zero," the court concluded that the firm "flunks the independent-investor test."

The Tax Court applied the same rationale to a midsize law firm organized as a C corporation in *Brinks*. The law firm's compensation policy in that case required each shareholder to make a capital investment equal to about 30 percent of the shareholders' expected compensation. This resulted in contributed capital of $9.047 million in 2007. Thus, the Tax Court found that the record "established that [the law firm] had substantial capital even without regard to any intangible assets."[123] The law firm and the IRS stipulated that some amount of compensation paid to shareholder-employees should be treated as a disguised dividend. The issue before the court was whether to impose accuracy-related penalties under section 6662. Reviewing the case law in the Seventh Circuit, the Tax Court found that none of the authorities cited by the petitioner "refute the general principle that the owners of an enterprise with significant capital are economically entitled to a return on their investments," and rejected the idea that "capital is not a material income producing factor in a professional service business":

> We do not doubt the critical value of the services provided by employees of a professional service firm. Indeed, the employees' services may be far more important, as a factor of production, than the capital contributed by the firm's owners. Recognition of those basic economic realities might justify the payment of compensation that constitutes the vast majority of the firm's profits, after payment of other expenses — as long as the remaining net income still provides an adequate return on invested capital. But petitioner did not have substantial authority that *completely* eliminated its

[121] *Brinks*, T.C. Memo. 2016-20.

[122] *Mulcahy*, 680 F.3d at 871.

[123] *Brinks*, T.C. Memo. 2016-20.

> income and left its shareholder attorneys with *no* return on their invested capital.[124] [Emphasis in original.]

In sum, the Seventh Circuit and the Tax Court in *Brinks* have concluded that capital can be a material income-producing factor in larger professional service corporations. But at what point a professional service corporation is large enough so that capital will be considered a material income-producing factor is an open question. It is also worth noting that, at most, two cases have found compensation to be reasonable because capital was not a material income-producing factor.[125]

ii. Measuring equity.

It is not always clear what counts as equity of the corporation for purposes of the independent investor test.[126] As noted, the Seventh Circuit suggested that the "physical capital to support some 40 employees in multiple branches and . . . intangible capital in the form of client lists and brand equity" might all be equity that a hypothetical independent investor would expect to generate a return.[127] The Tax Court in *Pediatric Surgical Associates* also treated non-shareholder employment contracts as a capital asset, which might generate profit to the corporation.[128] And the Tax Court in *Brinks* looked at "invested capital," which was equal to membership contributions, regardless of how, if at all, that invested capital was used in the law firm.[129] But in both *Brinks* and *Pediatric Surgical Associates*, the Tax Court only had to determine whether an accuracy-related penalty was justified, not what the actual compensation (or rate of return for an independent investor) should be. Thus, in both cases the court did not engage in a thorough analysis of what constituted the equity of the firm.

In *Mulcahy*, the taxpayer offered that the firm's gross revenue for one year was an "appropriate measure of the firm's equity."[130] Using this measure of equity, the taxpayer calculated its annual rate of return on equity basically as the percent change in gross annual revenue from one year to the next. But the Tax Court found that this was an inappropriate way to measure the rate of return. The court found instead that the rate of return should be based on the annual net income compared with equity, not the change in gross revenue. Because the taxpayer had basically zero annual net income after taking into account shareholder compensation, the court concluded that the rate of return would be zero for any amount of equity. This approach to determining the rate of return on equity is consistent with the Seventh Circuit's approach in *Exacto Spring*, which compared the corporation's post-tax profit with its equity to determine the rate of return on equity.[131] Because the firm's rate of return on equity was zero, the Tax Court in *Mulcahy* concluded that it was "too low to create a presumption that the amounts claimed . . . were reasonable compensation."

Some courts have used the taxpayer's year-end reported equity or shareholder equity to determine the rate of return. In *Elliotts*, the taxpayer reported equity of $415,133 and net profit (less taxes and compensation paid to shareholder-employees) of $88,969. Thus, the Ninth Circuit found the rate of return on equity to be 21 percent.[132] The Tax Court in *Diverse Industries* used the taxpayer's equity reported on its federal income tax return to determine that the rate of return on equity would have been 133 percent.[133] More recently, the Tax Court in *Ginger Masonry*

[124] The *Brinks* decision does not appear to treat the independent investor test as a burden-shifting mechanism. Rather the court treats this test as sufficient to determine that the taxpayer lacked substantial authority for its "practice of paying out yearend bonuses to its shareholders that eliminated its book income." *Id.*

[125] The Tax Court interpreted its earlier decision of *Law Offices of Richard Ashare PC v. Commissioner*, T.C. Memo. 1999-282, as an example of a case in which "the firm . . . had minimal capital" as the shareholder had only invested $1,000 in the corporation. *See Brinks*, T.C. Memo. 2016-20; *see also McClung Hospital*, T.C. Memo. 1960-86.

[126] *B&D Foundations*, T.C. Memo. 2001-262 (noting that courts have measured equity as (1) the equity available at the beginning of the year, (2) the equity at the end of the year, and (3) the average equity throughout the year).

[127] *Mulcahy*, 680 F.3d at 871. Considering these capital assets of the firm, the court in *Mulcahy* stated that "when a thriving firm that has nontrivial capital reports no corporate income, it is apparent that the firm is understating its tax liability." *Id.* at 873.

[128] *Pediatric Surgical Associates v. Commissioner*, T.C. Memo. 2001-81.

[129] *Brinks*, T.C. Memo. 2016-20.

[130] *Mulcahy*, T.C. Memo. 2011-74, *aff'd*, 680 F.3d at 687.

[131] *Id.*, citing *Exacto Spring*, 196 F.3d at 833.

[132] *Elliotts*, 716 F.2d at 1247.

[133] *Diverse Industries Inc. v. Commissioner*, T.C. Memo. 1986-84. The court, nevertheless, found the amounts of compensation unreasonable in light of other circumstances.

used the year-end shareholder's equity compared with net profit to determine the taxpayer's rate of return on equity.[134] Similarly in *Heitz*, the court conceded that, based on the shareholder's reported equity, the corporation's rate of return would be more than 20 percent.[135] On appeal, the Seventh Circuit overturned the Tax Court's decision that the compensation was too low to be reasonable and stated that a 20 percent rate of return that the Tax Court had found would "overjoy" an independent investor.[136] But other courts have rejected reported equity as too simplistic. In *B&D Foundations*, for example, the Tax Court rejected the taxpayer's assertion that the return on equity should be based solely on the "founding shareholder's small initial investment" of $10,000.[137]

Even non-shareholder employees may be treated as part of the capital or equity of a corporation. In *Pediatric Surgical*,[138] for example, the court concluded that the pediatric firm was understating its assets because it was not counting "nonshareholder employment contracts." Thus, the court found an accuracy-related penalty was justified based on "the shareholder surgeons' utter indifference to the possibility that a portion of the annual prebonus profits might have been derived from collections generated by nonshareholder surgeons."[139] The taxpayer in *Brinks* sought to distinguish its case from *Pediatric Surgical*, arguing that any profit the law firm made "from the services of nonshareholder attorneys can be justifiably paid to its shareholder attorneys in consideration for business generation and other nonbillable services." But the Tax Court rejected this argument, albeit without providing much analysis of the issue. In *Mulcahy*, the Tax Court rejected a similar argument, finding that the taxpayer had not provided sufficient "evidence to allow us compare the relative value" of the shareholders' services with the services provided by the non-shareholders.[140]

iii. Rate of return.

Once a court has determined the appropriate measure of equity and calculated the taxpayer's rate of return, it still must decide what rate of return would satisfy an independent investor. The aggregate of several decisions regarding the appropriate rate of return has led some courts to conclude that "a return on investment of 10 percent to 20 percent tends to indicate compensation was reasonable."[141] But some courts have tried to be more scientific by either looking at the rate of return for comparable businesses or the average rate of return on equity for the years at issue. Even when it may be difficult to value a company, a court may find that a compensation policy that eliminates the possibility for a shareholder to receive a return on his or her investment fails the independent investor test.[142]

In *Elliotts*, the Ninth Circuit looked at the average return on equity for a defined period to determine whether the rate achieved by the taxpayer would have satisfied an independent investor. Noting that "the average rate of return on equity was 15 percent, based on corporate profit in relation to net book value," the court declared that a rate of 20 percent for the same period "would satisfy an independent investor."[143]

The methods of identifying the rate of return from comparable businesses can be quite complex. The expert for the IRS in *Multi-Pak* used three different methods of determining an expected rate of return.[144] For one method, the expert looked at the pretax rate of return on equity for eight publicly traded companies in similar fields as the taxpayer. For another method, the expert determined the expected rate of return by hypothesizing an independent investor who had

[134] *Ginger Masonry*, T.C. Memo. 1997-251.

[135] *Heitz v. Commissioner*, T.C. Memo. 1998-220.

[136] *Exacto Spring*, 196 F.3d at 839.

[137] *B&D Foundations*, T.C. Memo. 2001-262 (citing *Eberl*'s, T.C. Memo. 1999-211). *See also Aries Communications*, T.C. Memo. 2013-97 (return on equity analysis was too simplistic because it did not consider interparty loans).

[138] *Pediatric Surgical*, T.C. Memo. 2001-81.

[139] *Id.*

[140] *Mulcahy*, T.C. Memo. 2011-74, *aff'd*, 680 F.3d at 687.

[141] *Thousand Oaks*, T.C. Memo. 2013-10 ("the Court has found a return on investment of between 10 percent and 20 percent tends to indicate compensation was reasonable").

[142] *Mulcahy*, 680 F.3d at 874.

[143] *Elliotts*, 716 F.2d at 1247. Interestingly, the Tax Court in *Elliotts*, T.C. Memo. 1984-516, engaged in a somewhat thorough comparison of the taxpayer's rate of return in a specific part of his business, compared with other similar businesses, and concluded that an independent investor would not be satisfied.

[144] *Multi-Pak*, T.C. Memo. 2010-139.

just purchased a business similar to the taxpayer before the years at issue. From that perspective, the expert estimated a reasonable rate of return based on earnings before interest, taxes, depreciation, and amortization "as a percentage of the market value of invested capital for the similar companies." The expert also used the buildup method, which "determines a reasonable rate of return on an investment based on the expected return on assets with similar risk exposure."[145]

But using comparable companies to generate a rate of return on equity may be rejected when the court finds that the comparable companies are too dissimilar to the taxpayer. The Seventh Circuit overturned the Tax Court's decision in *Menard* in part because the formula used by the Tax Court ignored differences in the risk of the employees' compensation packages, the unique challenges faced by the companies, and the responsibilities and duties of the CEOs.[146] The Tax Court in *Multi-Pak* found neither the taxpayer's nor the IRS's experts "completely convincing" because the companies used to generate hypothetical rates of return by both experts were not sufficiently comparable.[147] The Tax Court noted that, in contrast to comparable companies, the taxpayer "was virtually debt free," and pointed out that because the taxpayer's expert did not account for this difference, the expert likely exaggerated the rate of return an independent investor would accept. So while an expert may use comparable companies to formulate a rate of return for a hypothetical independent investor, courts will scrutinize whether the companies are truly comparable.[148]

IV. Section 199A Deduction Potential Impact

The cases discussed above point to significant variation and uncertainty regarding the reasonable compensation standard. Even though the final regulations cabin the application of the section 199A(c)(4)(A) reasonable compensation limitation to income received by S corporation shareholders, there is the potential for substantial uncertainty and therefore disputes with the IRS regarding the standard.

In determining the amount of reasonable compensation that an S corporation should pay its shareholder-employees, taxpayers should be sensitive to the case law in their circuit. Under the well-established *Golsen* rule, the Tax Court (and the IRS) will generally follow the law of the circuit court in which an appeal would lie.[149] Thus, for taxpayers in most circuits, the multifactor analysis discussed above would be the governing standard. But even for those taxpayers, it will be important to note the factors that have been applied in their circuit, and whether those factors include an independent investor analysis. Taxpayers in the Second and Ninth circuits will have to be cognizant of how "the perspective" of an independent investor might color certain factors. And taxpayers in the Seventh Circuit will have to be prepared to show how their compensation allows for a "reasonable rate of return." Of course, in seeking to maximize section 199A deductions, taxpayers will want to limit the amount of "reasonable compensation." Thus, in that context, the rate of return will be viewed as a ceiling, rather than a floor, as is the case in the C corporation context.

To illustrate how these different standards could be applied to justify reasonable compensation in the section 199A context, we

[145] *Id.*

[146] *See Menard*, 560 F.3d at 627.

[147] *Multi-Pak*, T.C. Memo. 2010-139.

[148] Expert reliance on comparable companies and judicial skepticism of those comparisons extends beyond this factor. In *Haffner's*, T.C. Memo. 2002-38, for example, the Tax Court took issue with the comparable companies used by the taxpayer's expert to show that the employees' compensation was reasonable. In that case the court took issue with the difference in size, revenue, operation, and geography between the taxpayer and the comparable companies. *Id.*

[149] *See, e.g.*, Michael Saltzman and Leslie Book, *IRS Practice and Procedure*, para. 7C.03 (2d ed. 2002 and Supp. 2018-3) ("Under the long-standing *Golsen* rule, the Tax Court follows the precedent of the circuit court to which an appeal would follow."); Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, para. 118.6 (2d/3d ed. and 2018 Cum. Supp. No. 3) ("In *Golsen v. Commissioner*, decided in 1970, the Tax Court decided that 'better judicial administration 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.'"); Internal Revenue Manual section 35.7.2.2.1 (instructing IRS employees that "in the course of research, consideration should be given to the *Golsen* Rule . . . a self-imposed rule of the Tax Court that it will follow the rule of law laid down by the court of appeals to which an appeals from the decision in the case before it will lie"); IRM section 8.6.4.1.6.

posit a hypothetical taxpayer who is the sole shareholder-employee of an S corporation, "Rental Business" in Washington. Rental Business has two apartment buildings, each of which is valued at $1 million. The taxpayer is responsible for all management activities, including finding tenants, negotiating and executing lease agreements, maintaining the common areas and sidewalks, fixing any building issues such as leaks, and paying all property taxes. The taxpayer is married and files a joint return with her spouse. Rental Business is taxpayer's only source of income, and she has no deductions (other than, potentially, the section 199A deduction) that will reduce her taxable income.

According to the U.S. Census Bureau, the rental vacancy rate for Washington, D.C., was 5.7 percent in 2016 and 6 percent in 2017.[150] However, Rental Business's properties have had a steady average vacancy rate of only 4 percent during this period. According to the Bureau of Labor Statistics, the average annual pay wage for residential property managers in Washington D.C. for 2017 was $58,050.[151] Rental Business's net rental income for 2019 is $300,000 and Taxpayer's pro rata share of Rental Business's income is also $300,000, as she is the sole owner.

The taxpayer is excited to take advantage of the new section 199A deduction. The taxpayer has confirmed that Rental Business has a sufficient level of activity to qualify as a trade or business under section 199A, according to Notice 2019-9, 2019-4 IRB 403,[152] and is comfortable that Rental Business is not an SSTB under section 199A(d) and reg. section 1.199A-5.[153] Further, because the taxpayer's total taxable income (not including any section 199A deduction) is $300,000 and she files jointly, she does not need to worry about the Form W-2 wage/UBIA (unadjusted basis immediately after acquisition) limitation.[154] The taxpayer, however, must determine her QBI derived from Rental Business, which excludes the amount of "reasonable compensation."[155] She has never had to previously determine her compensation because section 1402(a)(1) explicitly excludes real estate rental income from self-employment tax. Thus, as an S corporation shareholder, the taxpayer historically has never considered what portion of the income she derived through Rental Business constituted reasonable compensation.

If the taxpayer is in a pure multifactor jurisdiction, the analysis is complicated and uncertain. There are, however, some markers that she can look to for help. First, considering that Rental Business performs better than its peers, at least by one metric (vacancy rate), it would be hard for the taxpayer to justify paying herself less than the average mean salary of $58,050.[156] Arguably, she should pay herself *more*. Similarly, the multiple and diverse roles she plays in the business countenances against understating her income. The taxpayer may face an examiner who believes that her compensation should be the combination of the $58,050 for residential property management and the $33,354 average annual pay for landscaping services.[157]

The taxpayer would prefer not to be paid so much. If she has $58,050 in reasonable compensation, $241,950 is left as QBI. Accordingly, she would be entitled to a deduction equal to 20 percent of this or $48,390. If her marginal tax rate is 24 percent,[158] the deduction saves her about $11,613 each tax year. If, however, the taxpayer conducted the Rental Business in another jurisdiction, say Helena, Montana, where

[150] U.S. Census Bureau, "Rental Vacancy Rates for the 75 Largest Metropolitan Statistical Areas: 2015-Present."

[151] Bureau of Labor Statistics, "Quarterly Census of Employment and Wages."

[152] Notice 2019-7, 2019-9 IRB 740, provides a safe harbor under which a rental real estate enterprise that meets certain criteria will be treated as a trade or business for purposes of section 199A.

[153] Even if Rental Business were an SSTB, the taxpayer's income is below the threshold at which this would limit her section 199A deduction. *See* section 199A(d)(3).

[154] *See* section 199A(b)(3); reg. section 1.199A-1(c). In this respect, the taxpayer is in good company: The JCT estimates that for the 2019 tax year more than 95 percent of taxpayers claiming the section 199A deduction will be below the $315,000/$157,500 threshold. JCT, "Overview of Deduction for Qualified Business Income: Section 199A," at 30 (Mar. 2019).

[155] Section 199A(c)(4)(A); reg. section 1.199A-4(b)(2)(ii)(H).

[156] In *McAlary v. Commissioner*, T.C. Summ. Op. 2013-62, an IRS expert convinced the Tax Court that reasonable compensation was considerably more than the taxpayer's papered salary of $24,000 in part by multiplying the median hourly rate for the taxpayer's occupation, according to the California Occupational Employment Statistics Survey, by the number of hours the taxpayer worked during the year.

[157] Census Bureau, *supra* note 150.

[158] *See* section 1(j)(2)(A) for the rates applicable to joint filers through 2025.

the average annual pay for residential property managers was only $30,975 in 2017, her QBI could be justified as high as $269,025 and her resulting deduction would be $53,805, resulting in a tax savings of $12,913.[159]

But suppose instead that the taxpayer resides in the Seventh Circuit. Under the pure "independent investor analysis," the taxpayer's reasonable compensation analysis is focused on how much income she must leave in the business to provide a satisfactory return to an independent investor. Assuming that, after expenses, the average return on capital of rental property in her market is 10 percent, then the (net) return on capital for her two buildings is $200,000 (10 percent of $2 million). Accordingly, there would be a presumption that the remaining income, $100,000, is reasonable compensation. Under section 199A, this higher compensation hurts her bottom line. The taxpayer has only $200,000 to claim as QBI. Her deduction is only $40,000 and her tax savings is only $9,600. It will be up to the taxpayer to argue why, in her context, an independent investor would demand a *higher* rate of return.

The taxpayer may want to argue that her properties are particularly vulnerable to economic swings or that the properties have some other unique risk profile for which an investor would demand a higher rate of return. For example, the taxpayer may argue that a boom in the construction of new rental properties puts her own income stream at risk.[160] The taxpayer could also point to a nearly limitless number of risk factors — for example, federal regulations, general economic risks, and changes in demographics — that might help her argue for a higher rate of return (and consequently higher QBI).

The application of the independent investor test to section 199A gets more complicated when we look at the consequences for a service business. For example, imagine the taxpayer does not own any residential real estate but instead provides through a wholly owned S corporation property management services to rental property owners in the area. Assume the S corporation (and the taxpayer) derives $300,000 of net income from providing these services. Under the multifactor approach, the taxpayer's compensation and QBI does not significantly change as compared with the Rental Business. Looking at other similarly situated property managers in Washington, D.C. (we assume) she should pay herself at least $58,050. If she does not pay herself any more than that, she will have $241,950 QBI and a total tax savings of $11,613. In other words, the analysis under the multifactor approach produces the same outcome, assuming all other facts are the same.

Under the independent investor analysis, however, the analysis changes significantly. A court may follow Posner's "pane of glass" notion and find that there is no meaningful distinction between the income of the business and the taxpayer's compensation for her services because now the taxpayer is in the service business. If that is the case, the taxpayer would have to pay herself most if not all of the $300,000 as compensation. She would have no QBI and no tax savings under the new section 199A. Another way of articulating this idea is to say that capital is not a material income-producing factor in the taxpayer's property management business, which under Posner's view would imply the taxpayer is not entitled to *any* section 199A deduction.

One could certainly argue that such an approach is inconsistent with section 199A, which clearly permits service-based businesses to qualify for the deduction (indeed, without the SSTB limitation or the Form W-2 wage/UBIA limitation for those taxpayers with incomes below the $157,500/$315,000 threshold).[161] But it is not clear whether a court would agree that Congress implicitly blessed service-based businesses' claim to at least some section 199A benefits, or conclude that, under the independent investor analysis, all amounts attributable to services constitute "reasonable compensation."

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[159] Of course, this assumes that Rental Business was able to earn the same income in Helena as in Washington.

[160] *See* Prashant Gopal, "Rental Glut Sends Chill Through the Hottest U.S. Housing Markets," Bloomberg (Sept. 7, 2018).

[161] In fact, the House proposal of the TCJA included a provision that would have allowed "capital-intensive specified service activities" to still claim the benefits of section 199A, although the authors have not found an example of a "capital-intensive specified-service activity" in the *Congressional Record* or the legislative history of the TCJA. *See, e.g.*, Conf. Rep. at 205-224 (2017).

The *Brinks* decision also suggests opportunities for a service business to engage in creative tax planning. The Tax Court in *Brinks* used the "invested capital" of a law firm to determine that without any return on that capital, the firm's compensation to its employee-shareholders was unreasonable. But, as previously noted, the court did not consider whether the capital was material to the production of the firm's income. This rationale could allow businesses to create QBI by simply contributing capital.

For example, imagine a small two-member law firm (an SSTB) that averages $500,000 each year. Assuming the law firm's members are married, file jointly, have no other sources of income, and share the law firm's income 50/50, each member is below the $315,000 threshold and thus can claim income as QBI. Under an independent investor analysis, the firm may find that very little, if any, of its income is a return on capital. To correct this, the members may each make a capital contribution of $500,000. Thus, the firm's capital would be $1 million. Assuming a 15 percent rate of return, the firm now arguably should have QBI of at least $150,000 each year. For each partner, their compensation would be $175,000 and their section 199A deduction would be $15,000. Assuming an average tax rate of 24 percent, the resulting tax savings would be $3,600 per year. A larger amount of capital or a higher rate of return would increase that amount. Without more nuance, the reasoning of *Brinks* seems to support this outcome, regardless of how the capital is (or isn't used) by the firm.[162]

V. Conclusion

The law surrounding the reasonable compensation standard is byzantine, highly fact-intensive, and complicated. Moreover, unlike many of the most complicated federal tax issues related to corporations, the reasonable compensation rules are disproportionately more likely to affect relatively small businesses and their owners with modest income — hence the JCT's estimate that more than 95 percent of the estimated 27 million taxpayers claiming the deduction would be under the $315,000/$157,500 taxable income threshold.[163] Compared with large businesses, these taxpayers are less likely to have the ability (or inclination) to obtain the rigorous tax advice that will be needed to plan efficiently for the reasonable compensation standard. Yet given the significant overall cost of the section 199A deduction and the inverse relationship between QBI and reasonable compensation, one can expect the area to be a priority for IRS examiners.[164]

And, as set forth in the example above, the dollar amounts even for an individual taxpayer below the income threshold can be significant, especially over the lifetime of section 199A (which under current law runs through 2025). Hence, S corporations and their shareholders who paid little attention to reasonable compensation in the past (perhaps conservatively taking the position that their compensation was higher than necessary) would be well-advised to review their compensation methods to determine whether they can "reasonably" increase their section 199A deduction. ■

[162] If the capital is used to purchase the office space, the rent paid by the SSTB to itself (or to a related entity) will also be income of an SSTB. Reg. section 1.199A-5(c)(2).

[163] JCT, *supra* note 154, at 30.

[164] As noted, the JCT estimated that section 199A would reduce revenue by $414.5 billion through 2027 (the provision expires with respect to tax years beginning after December 31, 2025). JCX-67-17, *supra* note 4.