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IV

Compensation for Employee-Shareholders of Closely Held Corporations

David R. Fullmer

FEW SUBJECTS elicit greater interest on the part of the principal shareholder of a closely held corporation than the compensation he is to receive for services which he performs as a salaried employee of the corporation. Once a comfort level of income has

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been reached, the deep interest of the employee-shareholder is usually tax motivated. The fundamental tax considerations emanate primarily from the treatment of the corporation as a separate entity for tax as well as other legal purposes. In addition, however, a number of federal income tax laws which are related to the subject of employee compensation will, if followed, encourage certain courses of action by granting more favorable tax treatment. This use of the tax laws as a vehicle for reflecting and implementing social policies has been responsible for the development of the "package" concept of compensation which currently includes fringe benefits, life insurance, death benefits, and other forms of deferred compensation, in addition to the traditional forms of salary and bonus compensation. Since the objective of the principal shareholder-employee of a closely held corporation is usually to maximize after-tax income, it is essential that the tax adviser know the component parts of a compensation package and which ones should be selected in order to produce the best tax results. Compensation packages, like a fine suit of clothes, require expert tailoring to meet the demands of the situation, not careless padding and stretching.

It is not possible in one article to present a comprehensive analysis of the total compensation picture. This discussion will be limited to several areas of the overall subject which should be of particular interest and current relevance to the principal employee-shareholder of a closely held corporation.

I. THE VIEW FROM THE CORPORATE LEVEL

A. *What is Reasonable Compensation?*

Compensation for services rendered by an employee will be deductible by the corporation as an ordinary and necessary business expense only if, and to the extent that, the compensation is reasonable in amount.¹ The reasonableness of compensation will naturally be scrutinized more carefully when the employee receiving the compensation is also a substantial shareholder.² The reason for this is obvious. To the extent corporate earnings can be distributed as deductible compensation instead of as nondeductible dividends, double taxation is avoided.³ This leads to the question of how much is "reasonable."

The poet Robert Burns unknowingly captured the problems of determining what constitutes reasonable compensation when he wrote:

*O wad some Pow'r the giftie gie us
To see oursels as ithers see us!*⁴

There is no more subjective factual determination in the tax law than the attempt to place a dollar figure on the value of a man's services.⁵ Reasonableness depends on the point of view adopted. Therefore, it is not an infrequent occurrence for an employee-shareholder to value his services more highly than does an examining officer of the Internal Revenue Service. In such cases, it behooves tax counsel to introduce an element of objectivity into the compensation deliberations, hopefully at the planning stage. To do this effectively, he should first realize that, with a few possible exceptions, the compensation which must meet the reasonableness test is

¹ INT. REV. CODE OF 1954, § 162(a)(1) [hereinafter cited as CODE §].

² Darco Realty Corp. v. Commissioner, 301 F.2d 190 (2d Cir. 1962), *affirming* 30 P-H Tax Ct. Mem. 610 (1961); Heil Beauty Supplies, Inc. v. Commissioner, 199 F.2d 193 (8th Cir. 1952), *affirming* 19 P-H Tax Ct. Mem. 1015 (1950); Ingle Coal Corp. v. Commissioner, 174 F.2d 569 (7th Cir. 1949), *affirming* 10 T.C. 1199 (1948).

³ Throughout this discussion the assumption is made that an election under Subchapter S (CODE §§ 1371-77) is either impossible or undesirable. However, the subject of reasonableness of employee-shareholder compensation may become a disputed issue even if such an election has been made. See Cowen, *Many Potential Problems Are Inherent in Subchapter S Election*, 17 J. TAXATION 86, 88 (1962). Where the shareholders are members of a family, the Commissioner may take the position that an employee's compensation is unreasonably low for the services rendered. CODE § 1375(c); Treas. Reg. § 1.1375-3 (1959) [hereinafter cited as Reg §]. See also Henry D. Duarte, 44 T.C. 193 (1965).

⁴ Robert Burns, *To a Louse*.

⁵ Huckins Tool & Die, Inc. v. Commissioner, 289 F.2d 549 (7th Cir. 1961).

the aggregate dollar amount of all forms of compensation paid or payable to the employee.⁶ The aggregate dollar amount includes all compensation which is currently taxable to the employee as well as some that is not. In addition, counsel should realize that there are no private rulings, published guidelines, or other forms of advance approval by the Internal Revenue Service on what is reasonable in the particular situation.⁷

In light of the foregoing factors, it is natural that counsel would turn to the case law for guidance. However, he will find that it appears to be a jungle of meaningless precedent.⁸ There are probably more reasonableness-of-compensation tax cases than any other single kind, but it can be said quite honestly that never have so many opinions furnished so little specific help in so important an area.⁹ The most the cases really do is provide a series of signposts that point along the reasonableness trail. A study of these cases reveals that some factors have been emphasized more than others by the courts in determining reasonable compensation.¹⁰ Several of

⁶ Reg. § 1.404(a)-1(b) (1956); Rev. Rul. 90, 1958-1 CUM. BULL. 88.

⁷ Rev. Proc. 64-31, 1964-2 CUM. BULL. 947.

⁸ See *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949), for statement of basic reasonableness test.

⁹ For a discussion and annotation of some of the many reasonableness cases, see 2 CCH 1966 STAND. FED. TAX REP. ¶ 1372.015-144 (for a compilation of cases by industry); 4 MERTENS, FEDERAL INCOME TAXATION §§ 25.68-81 (1960).

¹⁰ A partial listing of the various factors used most often to support a finding of reasonableness of compensation would include:

(1) Qualifications and training great (age, schooling, work experience, unique skills, reputation in the trade and with fellow employees and customers, problem-solving ability, inventiveness, new products introduced, and innovations in business techniques), as illustrated in *Mahaska Bottling Co.*, 31 P-H Tax Ct. Mem. 1695 (1962);

(2) Long hours worked with little vacation;

(3) Scope of services broad, often performed by several persons in similar companies;

(4) Type of services highly complex, personal, detailed or demanding, coupled with a scarcity of skilled people to perform them;

(5) Sudden increase in compensation related to increased duties or responsibilities in business;

(6) Position of high responsibility in large company, having varied and complex managerial requirements;

(7) Rapid growth and prosperity of the company directly attributable to the employee's services;

(a) Growth not fortuitous (war) or temporary (windfall), or merely the result of general economic conditions;

(b) Growth greater than others in the same industry;

(8) Employee's services enabled company to survive when others in the same industry failed;

(9) Compensation within the range paid in the industry for like ser-

these factors deserve special attention. An obviously important element is the success of the enterprise including its growth, expansion, and increase in gross income.¹¹ If the corporation's success can be related to the efforts of the employee whose compensation is being questioned, a high salary will likely be found to be reasonable.

A second factor which has been emphasized is the extensive quality and quantity of skilled services performed by the employee.¹² In this respect, the busier and more experienced the employee is, the better are his chances.

vices under like circumstances, as illustrated in *Fotocrafters, Inc.*, 29 P-H Tax Ct. Mem. 1555 (1960);

(10) Compensation same or below that paid for similar services by a publicly held corporation;

(11) High-paying industry due to keen competition, lack of job security, and executive "raiding";

(12) Company's geographic location undesirable (climate, remoteness, high cost of living) necessitating above average compensation levels to attract and retain competent personnel;

(13) Same compensation considered and allowed in full by Commissioner in prior years;

(14) Compensation same as that paid to predecessor;

(15) No sudden sizeable increase in compensation corresponding to increased profits;

(16) Past compensation inadequate;

(17) No great disparity between compensation paid shareholder and nonshareholder salaried employees;

(18) Compensation paid pursuant to an employment agreement entered into before the services were rendered;

(a) Compensation reasonable under circumstances existing when contract executed, as illustrated in Reg. § 1.162-7(b)(2) (1958);

(b) Agreement authorized and formally approved by Board of Directors;

(c) Arm's length agreement — "free bargain," as illustrated in *Harolds Club v. Commissioner*, 340 F.2d 861 (9th Cir. 1965);

(i) Independent Board of Directors — totally or partially;

(ii) Employee a minority shareholder;

(iii) Employee not controlling shareholder when contract executed;

(d) Contingent compensation:

(i) Customary in the trade;

(ii) Not related to or dependent upon percentage of stock ownership;

(iii) Contingency related to nature of services to be performed, as illustrated in *James J. McHale Co. v. United States*, 151 F. Supp. 115 (N.D. Ohio 1957);

(19) Bonus not large, not paid at end of the year, and not paid proportionate to stock ownership;

(20) Good earnings and dividend history;

(21) Compensation a low percentage of sales and net profit;

(22) Long-established plan of paying basic salary plus percentage of net profit, as illustrated in *Locke Mach. Co.*, 16 P-H Tax Ct. Mem. 261 (1947), *aff'd*, 168 F.2d 21 (6th Cir.), *cert. denied*, 335 U.S. 861 (1948).

¹¹ See, e.g., *Capitol Mkt. v. United States*, 207 F. Supp. 376 (D. Hawaii 1962).

¹² *Ibid.*

Another technique frequently utilized in cases where the employee-shareholder has had many years of service is to show the effect that inflation and higher living costs have had on his compensation.¹³ It is likely that both the employee and the examining officer will be surprised when they see the employee's current compensation expressed in terms of 1939 or 1945 dollars.

It is generally conceded, however, that the most important factor in determining reasonableness is whether the employee's compensation is within the range paid in the industry for like services.¹⁴ But it is often difficult to establish grounds of similarity, particularly in the case of small closely held corporations where the work of the principal shareholder may encompass everything from executive to janitorial functions.¹⁵ In fact, it is often easier in such situations to attack comparables than it is to defend them.

B. Importance of Planning and Preparation

If an officer-shareholder's aggregate annual compensation exceeds 35,000 dollars or three per cent of the corporation's sales, or ten per cent of its net after taxes, it should be assumed that the reasonableness of his compensation will eventually have to be defended. In this area, as in so many other areas of tax law, advance planning is essential. For example, before the services are to be performed, a board-approved employment agreement should be executed which contains all of the favorable facts available. Contingent compensation invites the closest scrutiny and, therefore, deserves the most careful planning.¹⁶ If possible, contingent compensation should be tied to the type of services to be performed and a maximum limitation placed upon it. Payments which are proportionate to stock ownership should be avoided. A sudden and unexplainable increase in compensation or payment of a year-end "incentive" bonus to a substantial or sole shareholder could create significant problems. As the Tax Court has stated: "[F]or a sole

¹³ Job P. Wyatt & Sons v. Robertson, 49-2 U.S. Tax Cas. 697 (M.D.N.C. 1949).

¹⁴ Locke Mach. Co. v. Commissioner, 168 F.2d 21 (6th Cir. 1948).

¹⁵ 4 MERTENS, *op. cit. supra* note 9, § 25.72.

¹⁶ Reg. § 1.162-7(b) (2) (1958). The drafter should consider putting a provision in the employment agreement whereby the employee is obligated to repay the corporation the amount of any compensation which is *both* disallowed as a deduction and taxable to the employee. *United States v. Lewis*, 340 U.S. 590 (1951); COBE § 1341; General Counsel's Memorandum 16730, XV-1 CUM. BULL. 179 (1936).

owner to pay himself a bonus as an incentive to do his best in managing his own business is nonsense."¹⁷

If the Commissioner and the taxpayer are unable to agree on the subject of reasonableness, there are several important procedural considerations which should be weighed before a decision is made to litigate. First, the Commissioner's determination of reasonableness is *prima facie* correct and the burden is on the taxpayer to overcome this presumption.¹⁸ The fact that this same issue was litigated just a few years ago and the compensation was considered and approved on all subsequent audits is not necessarily decisive. What may have been reasonable compensation in a past year may be unreasonable in a subsequent year. Prior history may very well have strong evidentiary value, but it will not foreclose further litigation on the same issue.¹⁹

The taxpayer's degree of success in litigating reasonableness cases is quite impressive in view of the fact that many of the cases in which the facts tend to favor the taxpayer are settled at some administrative stage prior to trial. The taxpayer's success at any stage will usually depend on the degree to which he and his representatives have properly prepared.²⁰ A study of the reasonableness cases won by the taxpayer also reveals the importance of opinion testimony by expert witnesses. The government, for reasons best known to it, often does not attempt to present a persuasive case to support its determination of reasonableness. This deficiency can be fatal to the government's case if the opinion on reasonableness of

¹⁷ *University Chevrolet Co.*, 16 T.C. 1452, 1455 (1951). *But see* *Safety Eng'r & Supply Co. v. United States*, 65-2 U.S. Tax Cas. 96948 (N.D. Ala. 1965).

¹⁸ *Botany Worsted Mills v. United States*, 278 U.S. 282 (1929). Absence of evidence on an important factor can bear on whether the taxpayer has met the burden of proof. *Miles-Conley Co. v. Commissioner*, 173 F.2d 958 (4th Cir. 1949), *affirming* 10 T.C. 754 (1948); *Griswold Rubber Co.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65033 (Feb. 18, 1965).

¹⁹ Determination of reasonableness is evidence in one year but not *res judicata* or collateral estoppel in another year. *Burford-Toothaker Tractor Co. v. Commissioner*, 192 F.2d 633 (5th Cir. 1951); *Stoddard v. Commissioner*, 141 F.2d 76 (2d Cir. 1944); *Glenshaw Glass Co.*, 13 T.C. 296 (1949), *acq.*, 1950-1 CUM. BULL. 2; *Sterno, Inc.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65023 (Feb. 9, 1965). Failure of Commissioner to disallow for earlier year is evidentiary, but not binding. *Ridgewood Provisions, Inc.*, 6 T.C. 87 (1946), *acq.*, 1946-1 CUM. BULL. 4.

²⁰ *Compare* *Lewis Food Co. v. United States*, 193 F. Supp. 611 (S.D. Cal. 1961), *with* *Lewis Food Co. v. United States*, 64-1 U.S. Tax Cas. ¶ 9386 (S.D. Cal. 1964); *compare* *Sterno, Inc.*, 28 P-H Tax Ct. Mem. ¶ 59241 (1959), *aff'd*, 286 F.2d 548 (2d Cir. 1961), *with* *Sterno, Inc.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65023 (Feb. 9, 1965).

the taxpayer's impartial expert remains uncontradicted and unimpeached.²¹

C. Treatment of Compensation Deemed Excessive

The portion of an employee-shareholder's compensation ultimately determined to be unreasonable and excessive will generally not be deductible by the corporation under some alternative theory.²² From the standpoint of the employee-shareholder, such nondeductible excess will still be taxable to him as a dividend²³ or simply as compensation,²⁴ unless and to the extent that he can show that it was either a nontaxable gift²⁵ or the portion of total compensation attributable to a nontaxable fringe benefit, such as his share of the company's contribution to its qualified retirement plans.

II. THE VIEW FROM THE EMPLOYEE-SHAREHOLDER LEVEL — FRINGE BENEFITS

Most employee-shareholders are sufficiently sophisticated in the complexities of tax law to know that under certain circumstances their taxable compensation income may include, in addition to salary, certain indirect payments as well as the value of other economic benefits conferred upon them by the corporation. Examples of indirect compensation would be payment by the corporation of the employee's personal, living or family expenses,²⁶ the improper use

²¹ *Lockwood Realty Co. v. Commissioner*, 264 F.2d 241 (6th Cir. 1959); *R. P. Farnsworth & Co. v. Commissioner*, 203 F.2d 490 (5th Cir. 1953); *Roth Office Equip. Co. v. Gallagher*, 172 F.2d 452 (6th Cir. 1949); *Wright-Bernet, Inc. v. Commissioner*, 172 F.2d 343 (6th Cir. 1949). *But see Golden Constr. Co. v. Commissioner*, 228 F.2d 637 (10th Cir. 1956); *Builders Steel Co. v. Commissioner*, 197 F.2d 263 (8th Cir. 1952).

²² Such as additional rent for property leased from the shareholder. *Roehl Constr. Co.*, 17 T.C. 1037 (1951).

²³ Reg. §§ 1.162-7(b)(1), -8 (1958). See *Robert R. Walker, Inc.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65028 (Feb. 16, 1965).

²⁴ *Sterno Sales Corp. v. United States*, 65-1 U.S. Tax Cas. 95515 (Ct. Cl. 1965).

²⁵ CODE § 102.

²⁶ Reg. § 1.61-2(d)(3) (1957); Rev. Rul. 130, 1957-1 CUM. BULL. 108 (vacation); Reg. § 1.162-2(c) (1958) and Rev. Rul. 9, 1964-1 CUM. BULL. 65 (wife's traveling expenses). These and similar payments are not deductible by the employee (CODE § 262) or by the corporate employer unless paid as additional (reasonable) compensation. *Atlanta Biltmore Hotel Corp. v. Commissioner*, 349 F.2d 677 (5th Cir. 1965); *Robert R. Walker, Inc.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65028 (Feb. 16, 1965). *Bell Oldsmobile, Inc.*, 32 P-H Tax Ct. Mem. 372 (1963). It is possible that some employers will begin to treat certain entertainment type expenses as additional employee compensation in order to avoid the danger of a deduction disallowance under CODE § 274(a). CODE § 274(e)(3); Reg. § 1.274-2(f)(2)(iii) (1963).

of expense accounts,²⁷ allowance of a bargain purchase of corporate property,²⁸ and the personal use of corporate property, personnel, services, and facilities.²⁹ It is probably equally well known that certain types of corporate payments, such as reimbursement for business³⁰ or moving expenses,³¹ or the assumption of the cost of meals or lodging furnished on the business premises for the convenience of the employer,³² are not taxable to the employee, either as compensation or otherwise. Between these two areas of general knowledge lies a vast gray area of uncertainty for many employee-shareholders. A scholarly discussion of even one of the topics in this middle area is naturally beyond the scope of this article. The highly technical topics, such as stock plans for employees³³ and qualified tax-exempt retirement plans,³⁴ can only be mentioned. But certain highlights in some of the traditionally popular areas warrant more attention.

A. Accident and Health Benefits

(1) *Types of Excludable Contribution Plans.*—Company contributions to an accident or health plan, which compensates an employee in the case of personal injuries or sickness, are deductible by

²⁷ Abuses in the travel, entertainment and business gift areas should be substantially curtailed by CODE § 274 and the Commissioner's substantiation requirements. Reg. § 1.274-5 (e) (1) (1962); Rev. Rul. 144, 1963-2 CUM. BULL. 129. See also Graichen, *Effect of T and E Disallowances Upon Employer, and Employee, Officer, Stockholder*, N.Y.U. 22D INST. ON FED. TAX 843 (1964).

²⁸ See Reg. § 1.61-2(d) (2) (1957), as amended, T.D. 6696, 1963-2 CUM. BULL. 23; George S. Carter, 36 T.C. 128 (1961); James H. Knowles, 24 CCH Tax Ct. Mem. 129 (1965), *aff'd per curiam*, 355 F.2d 931 (3d Cir. 1966).

²⁹ Rental value of living quarters: *Atlanta Biltmore Hotel Corp. v. Commissioner*, 349 F.2d 677 (5th Cir. 1965); *R. A. Heintz Constr. Co. v. United States*, 65-2 U.S. Tax Cas. 96043 (D. Ore. 1965); *Gordon S. Dole*, 43 T.C. 697, *aff'd*, 65-2 U.S. Tax Cas. 96859 (1st Cir. 1965); *Charles A. Frueauff*, 30 B.T.A. 449 (1934); *Reynard Corp.*, 30 B.T.A. 451 (1934). Personal use of company car, yacht, lodge, etc.: *O'Neill v. Patterson*, 65-1 U.S. Tax Cas. 95576 (N.D. Ala. 1964); *Gordon S. Dole*, *supra*.

³⁰ CODE §§ 62(2)(A), 162(a), 274(d); Reg. § 1.162-2 (1958), as amended, T.D. 6306, 1958-2 CUM. BULL. 64; Reg. § 1.274-5 (1962).

³¹ CODE §§ 217, 62(8); Rev. Rul. 429, 1954-2 CUM. BULL. 53; Rev. Rul. 153, 1964-1 CUM. BULL. 70; Rev. Rul. 158, 1965-1 CUM. BULL. 34; Announcement 65-65, 1965 INT. REV. BULL. NO. 36, at 14; *England v. United States*, 345 F.2d 414 (7th Cir. 1965).

³² CODE § 119; O.D. 514, 2 CUM. BULL. 90 (1920).

³³ CODE §§ 421-25; Reg. § 1.61-15 (1963), as amended, T.D. 6706, 1964-1 CUM. BULL. 76. See also Meyer, *Stock Options: How the 1964 Act Changes Corporate Option Planning*, N.Y.U. 23D INST. ON FED. TAX 177 (1965).

³⁴ CODE § 401; Rev. Rul. 65-178, 1965 INT. REV. BULL. NO. 28, at 4; Rev. Proc. 31, 1962-2 CUM. BULL. 517.

the employer but are not included in the employee's gross income.³⁵ There are three basic methods by which a company may contribute to an accident or health plan which will compensate an employee in the case of personal injury or sickness.³⁶ First, contributions can take the form of premium payments on accident and health insurance or payments to a separate trust or fund which, in turn, either carries such insurance or makes direct benefit payments to employees.³⁷ Second, direct or indirect payments to an employee may also be fully excluded from gross income if and to the extent that they either reimburse him for expenses of medical care which he has not previously deducted or represent payments for permanent injury.³⁸ Third, payments made pursuant to a company plan may be excluded from an employee's gross income, subject to limitations as to time and amount, if paid as wages or in lieu of wages for a period of absence from work due to injury or sickness.³⁹ This is the familiar sick pay exclusion.

All three types of excludable accident and health benefits can be provided as incidental benefits under a company's qualified profit-sharing plan;⁴⁰ however, a pension plan, in order to be and remain qualified, may provide only for wage continuation payments in the form of a disability benefit, and for incidental accident and health benefits for *retired* employees.⁴¹

(2) *Coverage.*—The proceeds from an accident and health benefit plan may be excludable from an employee's gross income even though the provisions of the plan discriminate in favor of certain

³⁵ CODE § 106; Reg. § 1.162-10 (1958).

³⁶ It is not necessary that an accident and health plan be in writing or that the employee's rights to benefits under the plan be enforceable. Reg. § 1.105-5(a) (1956), as amended, T.D. 6722, 1964-1 CUM. BULL. 144. It is, therefore, possible to have a plan "evolve" into existence through custom or company policy. Notice or knowledge of the "plan" must be "reasonably available to the employee." *Ibid.*

³⁷ Reg. § 1.106-1 (1956); Rev. Rul. 146, 1961-2 CUM. BULL. 25.

³⁸ CODE §§ 105(b), (c).

³⁹ CODE § 105(d).

⁴⁰ Reg. § 1.401-1(b)(1)(ii) (1956); Rev. Rul. 164, 1961-2 CUM. BULL. 99. In 1962 the Commissioner informally took the position that payments to an employee from a qualified profit-sharing plan to reimburse him for expenses of medical care were taxable distributions under CODE § 402. Letter Ruling, October 1, 1962, P-H PENSION SERVICE ¶ 11989. The legal basis for this inequitable conclusion is, at best, tenuous. See Reg. § 1.402(a)-1(a)(1)(ii) (1956), as amended, T.D. 6823, 1965-1 CUM. BULL. 176, 177; Reg. § 1.72-15(d) (1963).

⁴¹ CODE § 401(h); Reg. § 1.401-1(b)(1)(i) (1956), as amended, T.D. 6722, 1964-1 CUM. BULL. 144; Reg. § 1.72-15(h) (1963). The deductibility of company contributions to qualified plans, both pension and profit-sharing, for accident and health type benefits is controlled by CODE § 404(a). See Reg. § 1.404(a)-1(a)(3) (1956), as amended, T.D. 6676, 1963-2 CUM. BULL. 41.

employees. The regulations state that a "plan may cover one or more employees, and there may be different plans for different employees or classes of employees."⁴² In short, the income exclusion rules may apply even though the plan intentionally favors one or more key salaried employees.⁴³ Theoretically this power of selectivity in a *separate* company accident and health plan should exist even though the covered employees are substantial shareholders. However, extremism in the pursuit of tax-free income for employee-shareholders is rarely a virtue.⁴⁴ Flagrant discrimination might cause the Commissioner to question the company's deduction on the ground that the payment was not an ordinary and necessary business expense. This possibility can be minimized not only by temperance but also by specifying, in the board resolution which establishes the plan, all of the corporate business purposes for making such payments.

A question often arises as to the feasibility of extending the benefits of an accident and health plan to members of the employee's family. In this respect, it should be remembered that the exclusions for reimbursement of medical expenses and payments for permanent injury relate not only to the employee himself but also to his spouse and dependents.⁴⁵ In addition, unlike the limitations on the medical expense deduction, there are no restrictions on the amount excludable from the employee's income under the accident and health provisions.

The issue of whether accident and health plan benefits received by employees who are past retirement age are excludable from gross income has provoked much controversy. One of the three excludable contribution plans — the sick pay exclusion — applies only if the employee would be at work were it not for his *own* injury or sickness.⁴⁶ This leads to the question of when is an employee no longer eligible for the exclusion because he is no longer expected to work. The position of the Internal Revenue Service is that the sick pay exclusion is lost once the employee reaches retirement age.⁴⁷ If the company has a pension or other similar retirement plan, re-

⁴² Reg. § 1.105-5(a) (1956), as amended, T.D. 6722, 1964-1 CUM. BULL. 144, 149.

⁴³ This is not true, of course, if the accident or health benefits form part of a qualified retirement plan. See text accompanying notes 40-41 *supra*.

⁴⁴ Technical Information Release No. 313, Announcement 61-37, 1961 INT. REV. BULL. NO. 16, at 52.

⁴⁵ Reg. § 1.105-2 (1956).

⁴⁶ Rev. Rul. 283, 1955-1 CUM. BULL. 17.

⁴⁷ Reg. § 1.105-4(a)(3)(i) (1956).

retirement age is normally considered to be the lowest age at which the employee could retire without company consent, and with retirement benefits computed at the full plan rate, if he were not previously disabled.⁴⁸ Disability benefit payments prescribed by such a plan prior to normal retirement can qualify as sick pay.⁴⁹ But there is a fine distinction between a disability benefit and an early retirement benefit, which the employee may have elected to take because of illness. The former will qualify for the exclusion while the latter may not.⁵⁰

If the company does not have a pension plan or if the sick pay is paid pursuant to a separate wage continuation plan, the company's customary retirement age for the class of employees to which the employee belongs will control the duration of his sick pay exclusion.⁵¹ This age may extend well beyond the normal retirement age of sixty-five if the employee continues to be regularly employed and would be at work but for his injury or illness.⁵² The Internal Revenue Service has stated that it will carefully scrutinize any situation where the retirement age of one class of employees is substantially higher than that of other classes.⁵³ It should be noted, however, that a person can render effective managerial services long after the age at which he could no longer perform services involving physical labor.⁵⁴

The rules on the exclusion of other types of accident and health payments to *retired former* employees are somewhat ambiguous. In 1962, the Internal Revenue Service ruled that a retired nonshareholder employee could exclude company payments to a plan provid-

⁴⁸ Rev. Rul. 76, 1957-1 CUM. BULL. 66, *modified*, Rev. Rul. 6, 1961-1 CUM. BULL. 15; Rev. Rul. 544, 1958-2 CUM. BULL. 43. See also Proposed Treas. Reg. § 1.105-4(a) (3), 29 Fed. Reg. 10521 (1964); Proposed Treas. Reg. § 1.79-2(b) (3), 29 Fed. Reg. 10518 (1964). *But see* Commissioner v. Winter, 303 F.2d 150 (3d Cir. 1962); Keefe v. United States, 247 F. Supp. 589 (N.D.N.Y. 1965); Tolmie v. United States, 246 F. Supp. 451 (W.D. Wash. 1965); Watson v. United States, 65-2 U.S. Tax Cas. 96694 (E.D. Tenn. 1965); Bigley v. United States, CCH 1966 STAND. FED. TAX REP. (66-1 U.S. Tax Cas.) § 9252 (E.D. Mo. Jan. 25, 1966); Barron v. United States, CCH 1966 STAND. FED. TAX REP. (66-1 U.S. Tax Cas.) § 9220 (W.D. Pa. Jan. 12, 1966) where the Commissioner's position on retirement age was rejected.

⁴⁹ Rev. Rul. 158, 1959-1 CUM. BULL. 34.

⁵⁰ *Ibid.*

⁵¹ Rev. Rul. 76, 1957-1 CUM. BULL. 66, as modified by Rev. Rul. 6, 1961-1 CUM. BULL. 15.

⁵² Rev. Rul. 192, 1961-2 CUM. BULL. 23.

⁵³ Rev. Rul. 76, 1957-1 CUM. BULL. 66, *modified*, Rev. Rul. 6, 1961-1 CUM. BULL. 15.

⁵⁴ Niekamp v. United States, 240 F. Supp. 195 (E.D. Mo. 1965); Barron v. United States, CCH 1966 STAND. FED. TAX REP. (66-1 U.S. Tax Cas.) § 9220 (W.D. Pa. Jan. 12, 1966); Jackson v. United States, 59-1 U.S. Tax Cas. 71281 (E.D. Wis. 1958).

ing hospital, medical and surgical insurance for both active and retired employees.⁵⁵ Thus, for purposes of section 106 a retired employee is apparently still an employee. The treasury regulations also provide that benefit payments from a qualified pension or annuity plan to retired employees for sickness, accident, hospitalization and medical expenses are to be treated "in the same manner as the payment of any other accident or health benefits under an employer-established plan."⁵⁶ The meaning of this statement is not entirely clear.⁵⁷

(3) *Application of Reasonable Compensation Test to Accident and Health Plan Benefits.*—The question often arises as to whether nontaxable accident and health benefit payments should be included in the employee's aggregate compensation for purposes of applying the reasonable compensation test. Legally, the answer is "no."⁵⁸ As a practical matter, however, particularly in the case of an employee-shareholder, the amount of any fixed, annual contribution to an accident and health plan may tend to influence an examining agent's view of the overall reasonableness of the compensation package. Some of the obvious advantages of accident and health benefits, particularly for employee-shareholders, are often overlooked by small, closely held corporations. This often is a good item to add to the compensation package especially when the employee's salary is approaching the top of the reasonableness ladder.

B. Life Insurance

Premiums paid by the company on company-owned ordinary life policies which insure the life of an employee-shareholder are neither deductible by the company⁵⁹ nor taxable as additional compensation to the employee so long as he does not have the right to designate the beneficiary of the proceeds.⁶⁰ Such insurance is often

⁵⁵ Rev. Rul. 199, 1962-2 CUM. BULL. 38.

⁵⁶ Reg. § 1.72-15(h) (1963), as amended, T.D. 6722, 1964-1 CUM. BULL. 144.

⁵⁷ Neither is it entirely clear as to what happens where such accident and health payments to retired former employees are not made from a qualified pension or annuity plan but rather from a separate employer-established accident and health plan.

⁵⁸ The payment is not deducted as compensation but is an ordinary and necessary business expense. Reg. § 1.162-10 (1958); Rev. Rul. 632, 1956-2 CUM. BULL. 101.

⁵⁹ CODE § 264(a) (1).

⁶⁰ *Yuengling v. Commissioner*, 69 F.2d 971 (3d Cir. 1934); Reg. § 1.61-2(d) (2) (1958). *But see* Rev. Rul. 184, 1959-1 CUM. BULL. 65, regarding the right to designate the beneficiary in certain situations, and *Edward D. Lacey*, 41 T.C. 329 (1963), *acq.*, 1964-2 CUM. BULL. 6.

carried to protect the corporation against the death of a key man, or is voluntarily used to fund the company's contractual obligation to the employee to redeem his stock at death,⁶¹ to pay deferred compensation upon retirement, or to pay a death benefit to his beneficiary.⁶²

Many qualified pension and profit-sharing plans also provide for insurance protection as an incidental benefit. However, in this case the life insurance premium cost, including the full cost of group term insurance, is currently taxable to the employee-participant as additional compensation.⁶³ Under the Revenue Act of 1964, employee-beneficiaries of company-carried group term life insurance are subject to taxation if and to the extent that the premium cost carried by the employer exceeds the sum of the cost of 50,000 dollars of coverage plus the employee's contribution toward the premium.⁶⁴ The cost of group term coverage is normally deductible by the employer — even for the portion not taxable to the employee — and there are no tax rules which limit the degree of selectivity as to coverage. However, many states have statutes regulating coverage and limiting the issuance of group term insurance to some maximum amount, usually less than 40,000 dollars.⁶⁵

Employer-paid insurance premiums which can be currently deductible as additional compensation, such as premiums on group term insurance or individual ordinary life policies owned by the employee, must first pass the "reasonableness" test when considered along with other forms of compensation paid to the employee during or on account of the taxable year.

C. *Deferred Compensation*

The deductibility of deferred compensation by the employer is controlled by section 404 of the Internal Revenue Code provided the conditions of section 162 (ordinary and necessary expense which is reasonable in amount) can first be satisfied.⁶⁶ Thus, with a

⁶¹ Rev. Rul. 184, 1959-1 CUM. BULL. 65.

⁶² Risk of surtax on unreasonable accumulation of earnings unless valid business purpose for insurance protection is established. CODE §§ 531-37. For rules on "split dollar" arrangements see Rev. Rul. 328, 1964-2 CUM. BULL. 11.

⁶³ CODE § 72(m) (3) (B); Reg. § 1.72-16(1963); Rev. Rul. 634, 1956-2 CUM. BULL. 291.

⁶⁴ CODE § 79; Rev. Rul. 28, 1965-1 CUM. BULL. 527.

⁶⁵ See, e.g., OHIO REV. CODE § 3917.01 (Supp. 1965).

⁶⁶ Reg. § 1.404(a)-1(b) (1956), as amended, T.D. 6676, 1963-2 CUM. BULL. 41; Reg. § 1.404(b)-1 (1956).

minor exception, such compensation is deductible under section 404 only in the year of payment regardless of the company's accounting method.⁶⁷

The forms of deferred compensation extend all the way from the well-known qualified and exempt pension, profit-sharing and stock bonus plans (in which company contributions are currently deductible, subject to certain limitations,⁶⁸ but participating employees are taxed only when benefits are distributed or made available to them⁶⁹) to contracts with individual employees⁷⁰ and death benefit payments, usually to the employee's widow, made either voluntarily or pursuant to agreement.

Of the many intricate subject areas under the general heading of deferred compensation, four topics are particularly relevant to this compensation survey and deserve a brief mention. First, it is important to keep in mind that while a company's contribution to a qualified retirement plan may not be taxable to a participating employee in the year when paid, the employee's share of that contribution *is* included in computing his aggregate compensation which must meet the reasonableness test in order to be deductible by the company.⁷¹ In the case of an individual contract of deferred compensation, reasonableness is determined at the time of payment but usually is based partly on the inadequacy of pre-retirement compensation and partly on the value of post-retirement advisory or consulting services to be rendered as a condition to continued payments.

The second area of interest relates to the types of situations in which the Internal Revenue Service will now issue favorable determination letters on salaried-only pension and profit-sharing plans. Four recent rulings published by the Service have formalized a change in thinking and practice in this area that has actually been in effect informally for quite some time.⁷² A salaried-only plan will no longer qualify if coverage primarily benefits employees in

⁶⁷ Reg. § 1.404(a)-1(c) (1956), as amended, T.D. 6676, 1963-2 CUM. BULL. 41. See also CODE § 404(a) (6).

⁶⁸ CODE §§ 404(a) (1), (2), (3).

⁶⁹ CODE §§ 402, 403, 72.

⁷⁰ Rev. Rul. 31, 1960-1 CUM. BULL. 174, *modified*, Rev. Rul. 279, 1964-2 CUM. BULL. 121.

⁷¹ Reg. § 1.404(a)-1(b) (1956), as amended, T.D. 6676, 1963-2 CUM. BULL. 41.

⁷² Rev. Rul. 66-12, 1966 INT. REV. BULL. NO. 3, at 7; Rev. Rul. 66-13, 1966 INT. REV. BULL. NO. 3, at 9; Rev. Rul. 66-14, 1966 INT. REV. BULL. NO. 3, at 11; Rev. Rul. 66-15, 1966 INT. REV. BULL. NO. 3 at 12.

the prohibited class, such as officers, shareholders, supervisors or other "highly compensated" employees. This will be the case even though the nonsalaried employees are represented for collective bargaining by a union which has not demanded any type of qualified deferred compensation plan. Even though the salaried-only plan may meet the coverage requirements when considered in conjunction with a separate plan for hourly employees, it will not qualify if the level of contributions or benefits, when compared to those provided in the plan for the hourly employees, discriminates in favor of employees in the prohibited class. Because none of these recent rulings contains a "savings clause" with respect to effective date of application, it would be advisable to review any salaried-only plan which has previously been ruled qualified and exempt in order to see if it continues to meet the current Internal Revenue Service standards of nondiscrimination.

A third question concerns the economics of individual deferred compensation arrangements, particularly for middle-age officer-shareholders. The basic theory of such deferred compensation is postponement of income to low bracket years so that more will remain after taxes. The premise of "low-bracket years later on" often proves erroneous, however, in the case of an employee-shareholder who is many years away from retirement. In addition, during the postponement period the employee is usually giving up the after-tax earning power and potential appreciation of the deferred amount which is money that would not be subject to the reasonableness test because it was not paid by the company. If the company decides to fund its deferred obligation, it is necessary to tie up working capital in an expense that is not deductible in the years when incurred. With the top individual tax bracket presently down from ninety-one per cent to seventy per cent, some of the romance formerly associated with deferred compensation may begin to disappear, except from the paternalistic view of employee security. In order for deferred compensation to make economic sense, it must be carefully tailored to the facts and should be reviewed periodically to make sure that assumed facts have not changed.⁷³

The final deferred compensation point involves the direct payment by the employer of a death benefit to the deceased employee's

⁷³ Foote, *When Deferred Compensation Doesn't Pay*, Harv. Bus. Rev., May-June 1964, p. 99.

beneficiary, usually his widow. Such employer payments pursuant to a plan or contract can be tax-free up to 5,000 dollars⁷⁴ and are generally taxable as ordinary income from that point on. The tax status of *voluntary* payments in excess of 5,000 dollars has been the subject of much litigation under both the 1939 and 1954 Internal Revenue Codes. It is likely, however, that the frequency of this type of litigation will begin to decrease as corporate employers become more interested in protecting the deductibility of their payments. A business gift, if nontaxable to the recipient, is now deductible only up to twenty-five dollars (which really does not make much of a death benefit).⁷⁵ Treating the benefit as additional compensation of the deceased employee will probably protect the company's deduction, assuming the reasonableness test can be met,⁷⁶ but it will certainly minimize the widow's chances of successfully arguing that the payment was really intended as a nontaxable gift. Treating the death benefit as a non-gift, noncompensatory business expense might be successful, but one court rejected this theory by finding that the expense was not ordinary and necessary because of the absence of a corporate business purpose.⁷⁷

III. CONCLUSION

There is no magic formula for computing the reasonable, and therefore deductible, compensation of an employee-shareholder of a closely held corporation. Prior planning is important. General guidelines or factors have emerged through litigation which point toward a conclusion of reasonableness and factors which are obviously relevant to a particular fact situation should be utilized. A closely held corporation which is approaching the danger zone with respect to the surtax on unreasonably accumulated earnings usually can afford to be more liberal in determining the reasonable compensation of a principal employee-shareholder. Any portion

⁷⁴ CODE § 101(b).

⁷⁵ CODE § 274(b).

⁷⁶ E. R. Wagner Mfg. Co. v. United States, 235 F. Supp. 969 (E.D. Wis. 1964); Montgomery Eng'r Co. v. United States, 230 F. Supp. 838 (D.N.J. 1964), *aff'd*, 344 F.2d 996 (3d Cir. 1965); Weyenberg Shoe Mfg. Co., 33 P-H Tax Ct. Mem. 2198 (1964); Ida Maltzman, 33 P-H Tax Ct. Mem. 912 (1964); Reg. § 1.404(a)-1(b) (1956), as amended, T.D. 6676, 1963-2 CUM. BULL. 41; Reg. § 1.404(a)-12 (1956).

⁷⁷ Vesuvius Crucible Co., 24 CCH Tax Ct. Mem. 750 (1965), *aff'd per curiam*, CCH 1966 STAND. FED. TAX REP. (66-1 U.S. Tax Cas.) ¶ 9210 (3d Cir. Feb. 2, 1966).

found to be unreasonable will still serve to reduce accumulated earnings. If direct dollar compensation payments are approaching the top level of reasonableness, the addition of certain fringe benefits, such as an accident and health plan, group term life insurance, a qualified retirement plan, an individual deferred compensation arrangement, or contractual death benefit, should be considered. Finally, if the Internal Revenue Service raises the question of reasonableness, it should be remembered that this is an area in which many taxpayers have succeeded through the careful preparation of a strong offense.