

April 1, 1985

Mr. Sterling Manville  
Truly Pretentious Homes, Inc.  
123 Morning Star Drive  
Mill Valley, California 99999

Re: Response to inquiry of March 25, 1985 concerning proposed bonus plan for certain key employees

Dear Mr. Manville:

After conducting my research and careful review of your file, I have arrived at the following appraisal of your proposed bonus plan. Please note, in order that this firm may serve you and your corporation best, it is imperative that I have a complete understanding of all pertinent facts. Therefore, please contact me if any of the following facts that I have reiterated below are incorrect:

It is my understanding that Truly Pretentious Homes, Inc. is a real estate development company incorporated in the late 1970s in the State of California. The corporation builds primarily single family residences in Marin County, catering to mostly young, upwardly mobile working couples and singles who are employed in the high tech industries. Truly Pretentious Inc.'s trademark is its "Hollywood fronts" whereby only the street-side of its homes have any ornamentation.

The corporation is an accrual, calendar year taxpayer. It pays regular dividends which are comparable to other real estate development corporations. During the corporation's early years it made meager profits. However, 1985 is a banner year for the corporation, and it appears that Truly Pretentious Homes, Inc. will have large profits in 1985.

Truly Pretentious Homes, Inc. employs approximately five hundred persons. The corporation currently pays its employees within the mid-range to upper-end as employees in the same field. This has not always been the case with seven of its key employees. For this reason, and because the corporation will make large profits in 1985, the corporation would like to award these seven employees a cash bonus.

The goals of the proposed bonus plan are to give cash to the seven employees, declare and deduct cash in 1985 as a business expense of the corporation, and pay the cash in 1986. The terms of the proposed bonus plan will require the employees to pay back the cash should the corporation find itself cash poor in the future.

The seven employees which are to receive the cash bonuses are cash-basis taxpayers:

| <u>Employee</u>     | <u>Ownership Percentage</u> | <u>Salary</u> |
|---------------------|-----------------------------|---------------|
| President           | 51%                         | \$500,000     |
| Vice-President      | 10%                         | \$400,000     |
| Secretary-Treasurer | 10%                         | \$180,000     |
| Project Manager     | 1%                          | \$160,000     |
| Foreman             | 1%                          | \$140,000     |
| Foreman             | 1%                          | \$140,000     |
| Executive Secretary | 0%                          | \$80,000      |

None of these seven key employees wish to bring the cash into income until 1986.

In evaluating the foregoing facts and the goals of your proposed bonus plan I have arrived at the opinion that there are many issues which must be addressed if the bonus plan is to succeed. A discussion of these issues follow. Again, if any of the above facts are incorrect please contact me for re-evaluation.

### **DISCUSSION**

#### **Reasonable Compensation**

The Internal Revenue Code provides that there shall be a deduction of all ordinary and necessary business expenses paid or incurred during the taxable year, including a reasonable allowance for salaries and other compensation. I.R.C. § 162(a)(1) of the 1954 as amended. An employer may deduct bonuses as additional compensation when bonuses are paid in good faith and for services actually rendered. Treas. Regs. § 1.162-9. Thus, if the cash bonuses paid to the seven key employees are the purchase price for services preformed for the benefit of Truly Pretentious Homes, Inc., they are probably deductible.

The cash bonuses are “probably” deductible because the proposed bonus plan is not without its potential problems. The Internal Revenue Service holds corporations to the highest level of scrutiny when a corporation awards bonuses to employees who are also shareholders. *Nor-Cal Adjusters v. Commissioner*, 503 F.2d 359, 361 (9th Cir. 1974). This is especially true if the corporation has had an extremely profitable year, as has Truly Pretentious Homes, Inc. since it is the Service’s position that the bonuses are merely disguised dividends. *Id.* Therefore, if your proposed plan is ever the subject of an audit by the Internal Revenue Service, it is possible that the deduction of the cash bonuses by the corporation may be disallowed as to the six shareholder-employees on the basis that the bonuses are disguised dividends.

On the other hand, the courts take a somewhat different approach when addressing the issue of whether bonuses paid to shareholder-employees are reasonable compensation. Our own Ninth Circuit clearly has rejected the notion of the “automatic dividend rule”. *Elliotts Inc. v. C.I.R.*, 716 F.2d 1241, 1244 (9th Cir. 1983). In *Elliotts*, the United States Court of Appeals reasoned that the automatic dividend rule should not be applied in evaluating reasonableness of compensation awarded a shareholder-employee because (1) no statute requires profitable corporations to pay dividends, (2) not all investors demand dividends, some prefer high returns on investment, and (3) retained earnings may be the most rational source of financing for a small corporation. *Id.* As a result of the *Elliotts* decision, the courts within our circuit will not regard bonuses paid to shareholder-employees as disguised dividends on its face, although reasonableness of compensation is still required in determining whether the bonuses are a deductible item of expense.

In an analysis of whether bonuses paid to shareholder-employees are reasonable compensation, the Ninth Circuit makes an initial inquiry from the perspective of a hypothetical, independent investor. *Id.* With this hypothetical investor in mind the court utilizes several tests in making a determination as to whether the compensation is appropriate:

1. The shareholder-employee’s role in the corporation, which includes the position held by the employee, number of hours worked, and general importance of the shareholder-employee to the success of the corporation. *American Foundry v. Commissioner*, 536 F.2d 289, 291-2 (9th Cir. 1976).
2. A comparison of the shareholder-employee’s salary with those paid by similar corporations for similar services. *Pacific Grains, Inc. v. Commissioner*, 399 F.2d 603, 606 (9th Cir. 1968).
3. An examination of the character and condition of the corporation, including size as indicated by net sales, net income or capital value. *Id.*
4. An existence of a relationship which might permit a shareholder-employee to disguise a non-deductible corporate distribution. *Id.* Within this category large bonuses to owner-

executives are suspect if bonuses are not awarded to non-owner executives on the same level. *Nor-Cal Adjusters*, 503 F.2d at 361.

5. The bonus plan must be a formal, consistently applied program. *Pacific Grains*, 399 F.2d at 607.

No one single test is decisive as to whether the compensation is appropriate. *Id.* Thus, the courts within our circuit will determine the issue of reasonable compensation on a very subjective, case-by-case basis.

In conclusion, when making a decision whether to implement your proposed bonus plan it is important to note that you may risk being the subject of an audit by the Internal Revenue Service. However, should you decide that your proposed bonus plan is important enough to forge ahead, and the outcome of an audit is unfavorable, you may proceed through the courts. In my opinion, your proposed bonus plan has a very good chance of succeeding in the Ninth Circuit as far as reasonableness of the compensation because the seven key employees to whom you wish to award cash bonuses have provided invaluable services to your corporation and the cash bonuses are compensatory in nature.

#### Compensation for Services Rendered in Previous Years

As a general rule, additional compensation for services rendered in previous years to an employer is a deductible item of expense by an accrual-basis taxpayer when it is paid if there was no prior agreement or legal obligation to pay the compensation. *Lucas v. Ox Fibre Brush Co.*, 115 U.S. 111, 119 (1930). However, the additional compensation is proper, and therefore deductible, only where the prior services were compensated substantially less than what the market should, or would, pay. *Nicoll*, 59 T.C. 37, 50 (1972). Thus, since the seven key employees were under-compensated in previous years, the cash bonuses, in my opinion, are deductible by the corporation in regard to the issue of compensation for services rendered in previous years.

#### Timing of the Deduction

The amount of any item of expense which is an ordinary and necessary business expense shall be deducted for the taxable year which is the proper year under the method of accounting used in computing taxable income. I.R.C. § 461(a). Under the accrual method of accounting an item of expense is deductible by a corporation for the taxable year in which all of the events have occurred which determine the fact of liability and the amount of liability with reasonable accuracy. Treas. Regs. § 1.461-1(a)(2).

The fact of liability is the point in time when liability is fixed. The Internal Revenue Service takes an unyielding view, stating that there must be a current liability without any contingencies to pay. Rev. Rul. 72-34, 1972-1 C.B. 132. However, recent case law has determined that the fact of liability may include performance at a later date if the expense flows from a specific event in the current year. *Crescent Wharf & Warehouse Co. v. Commissioner*, 518 F.2d 772 (9th Cir. 1975). Hence, in following case law of the Ninth Circuit, the cash bonuses are in fact a liability in that year. A good way to establish the liability is by corporate resolution.

Secondly, under the all events test, the amount of liability must be determinable by computation based upon known or knowable factors. I.R.S. Letter Ruling 7831003. It is my understanding that you have already determined the amount of cash bonuses that will be awarded to the seven key employees, and therefore, you will have no problem meeting this part of the all events test.

Of note, as of the 1984 Tax Reform Act, the all events test cannot be satisfied by an accrual-basis taxpayer until there has been economic performance. I.R.C. § 461(h)(1). Under the economic performance test, the liability must arise from the seven employees providing the services to Truly Pretentious Homes, Inc. and may only be deductible by the corporation when these employees provide services. I.R.C. § 461(h)(2)(A)(i). Thus, the cash bonuses would not be deductible for 1985 under any circumstances were there no an exception.

As an exception to the economic performance test, an accrual-basis taxpayer need not satisfy the economic performance test when making payments of recurring items of expense in the ordinary course of business. I.R.C. § 461(h)(3). Accordingly, if your corporation wishes to include the cash bonuses as an item of expense on its Federal tax return for 1985, but actually pay the cash in 1986, it must fall under this exception. All four conditions must be met in order for this exception to apply:

1. The all events test, as discussed above, must be satisfied.
2. Payment of the cash bonuses must occur within a reasonable period of time, but no later than eight and one-half months after the closing of the corporation's taxable year.
3. The taxpayer consistently treats the item of that type as a recurring item.
4. The item is either material or an accrual of the item in the year in which all events were met results in better matching of income to which it relates.

In my opinion, the best way to show that the bonuses are a recurring item of expense is by, again, corporate resolution establishing that the bonuses will be paid, and then pay the bonuses to the seven key employees within eight and one-half months after the closing of Truly Pretentious Home, Inc.'s taxable year.

### Problem Areas in Timing of the Deduction

There are two potential problems with your proposed bonus plan in the area of timing the deduction for 1985. The first problem area relates to the terms of the bonus plan that would require the employees to pay back the bonuses to Truly Pretentious Homes, Inc. should the corporation find itself cash poor in the future. If the future includes 1985, and the employees never receive the cash, the corporation will not be able to take the deduction. *Dixie Pine Products v. Commissioner*, 320 U.S. 516, 519 (1933); *Stern-Slegman Products v. Commissioner*, 79 F.2d 289 (8th Cir. 1935); *Harrington*, 6 T.C. 720 (1956).

The second problem area concerns you as a 51% shareholder in Truly Pretentious Homes, Inc. In transactions between related taxpayers, an accrual-basis corporate taxpayer will be treated as a cash-basis taxpayer. I.R.C. § 267(a)(2). By definition you and Truly Pretentious Homes, Inc. are related taxpayers since you own more than 50% of the stock of the corporation. I.R.C. § 267(b)(2). Therefore, as long as you own more than 50% of the corporate stock, Truly Pretentious Homes, Inc. may not deduct the cash bonuses that you receive until it is included in your gross income.

### Timing of Includibility

The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer. I.R.C. § 451(a). The Internal Revenue Code places certain limitations on cash-basis taxpayers under the Doctrine of Constructive Receipt. Treas. Regs. § 1.451-2(a). These limitations require the cash-basis taxpayer to recognize income when it is accredited to the taxpayer's account, set apart or otherwise made available. *Id.* Thus, since the seven employees who are to receive the cash bonuses will not have the cash available to them until 1986, they will not have to include the bonuses as income until then. The Doctrine of Constructive Receipt applies to these seven employees regardless of when Truly Pretentious Homes, Inc. is allowed a deduction. Rev. Rul. 75-189 C.B. 142.

### Effect of Repayment on Employees

Under the Claim of Right Doctrine, income is includible upon actual or constructive receipt if the taxpayer appears to have unrestricted use of the income. *North American Oil Consolidated v. Burnet*, 286 U.S. 59 (1932). If the money must be paid back later, the individual taxpayer may deduct that repayment. *United States v. Lewis*, 340 U.S. 59 (1951). Therefore, if the seven employees are required to repay the cash bonuses to Truly Pretentious Homes, Inc., they will probably be able to deduct the repayment from that year's income.

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However, a problem may occur where the tax benefits of the repayment are less than the tax paid in the earlier year. Because of this Congress enacted section 1341 which was designed to give relief to taxpayers in this situation. *Van Cleave v. United States*, 718 F.2d 193, 195-6 (6th Cir. 1983). Section 1341 provides that the amount of tax reduction will be equal to the amount the taxpayer would have saved if s/he never received the income in the first place. I.R.C. § 1341(a). Should the seven employees be required to pay back the bonuses they must satisfy the following criteria in order to utilize the relief provision of section 1341:

1. The item included in gross income in the prior taxable year(s) must have appeared to have had unrestricted use by the taxpayer.
2. A deduction is allowable in that taxable year because it was established after the closing that the taxpayer did not have unrestricted use.
3. The amount exceeds \$3,000.
4. Then, the tax imposed shall be the lesser of the tax computed with such deduction, or the tax computed with such deduction minus the decrease in tax for the prior year(s) resulting solely from exclusion of such an item from gross income for prior taxable year(s).

#### CONCLUSION

In my opinion, most of the goals of your proposed bonus plan will succeed if the cash bonuses to the shareholder-employees are paid as compensation for services rendered for the benefit of Truly Pretentious Homes, Inc. However, I do not feel that the corporation will be able to deduct the cash bonus awarded to you as an item of expense for 1985 as long as you continue to own more than 50% of the shares of stock of Truly Pretentious Homes, Inc.

If you have any questions, or the goals or terms of your proposed bonus plan should change, please do not hesitate to telephone me.

Very truly yours,

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Arthur M. Attorney, Esq.

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