A Fringe Benefit Primer for the Closely Held C Corporation (Part I)

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This two-part article surveys basic techniques for selectively compensating key employees of closely held C corporations on a tax-favored basis, and the benefits and pitfalls of such strategies. Part I examines salaries and bonuses, interest-free loans and health and disability insurance.

A tax adviser to a closely held business should attempt to structure compensation and benefits packages that achieve favorable tax results for both the business and the affected employee. Certain employee benefits (generally, those specifically provided by statute) are excludible from an employee's gross income, while being fully deductible by the corporation when paid or accrued. Otherwise, the benefits should be arranged so as to create a "tax wash" between the company and the employee (i.e., if a benefited employee must include all or part of a benefit in gross income, the company should receive a full deduction when it pays or accrues the cost). The tax adviser should avoid circumstances in which a benefit program could result in full inclusion in an employee's income, with no offsetting deduction by the company (e.g., an actual or constructive dividend).

This article surveys the techniques for selectively compensating key employees of closely held C corporations on a tax-favored basis and the benefits and pitfalls. The methods are designed to help the shareholder-key employee satisfy his or her desire for benefits not granted proportionately or equivalently to other employees. Only methods of compensating key employees not subject to statutory nondiscrimination rules (or subject to less restrictive rules) are discussed.[1] Part I, below, examines salaries and bonuses, interest-free loans and health and disability insurance. Part II, in the November 2004 issue, will discuss group life insurance, split-dollar life insurance and nonqualified deferred compensation.

Certain of the benefits are not generally available (or sensible) for conduit entities, such as S corporations and partnerships. For example, a partnership would not need to deduct compensation to partners, as distributive shares have essentially the same effect. Similarly, S corporations are well known for undercompensating shareholder-employees, so as to avoid Social Security and payroll taxes. Nonqualified deferred-compensation arrangements generally make little sense for the owners of S corporations and partnerships—any income retained by the entity to informally fund a deferred obligation will flow through and be taxed to owners currently.

Current Compensation

The ultimate way to benefit a key employee in a closely held C corpora-

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[1] Fringe benefits subject to statutory nondiscrimination rules generally provide better or more certain tax results for the benefited employees. These include qualified retirement plans (Sec. 401), cafeteria plans (Sec. 125), self-insured medical reimbursement plans (Sec. 105(h)), voluntary employees' beneficiary associations (Sec. 501(c)(9)), group legal services plans (Sec. 120), educational assistance plans (Sec. 127), dependent care assistance programs (Sec. 129) and other tax-favored fringe benefits (e.g., qualified employee discounts, recreational facilities and qualified tuition plans).

Most statutory employee benefits that embody these nondiscrimination standards incorporate Sec. 414(b), (c) and (m), which aggregate all employees of commonly controlled and functionally related entities. If *most or all* employees of a closely held corporation are family or insider group members, benefits that embody strict nondiscrimination standards should be considered. In such a case, including all 1,000-hour-or-more employees becomes much more of a high-end tax shelter than a mere fringe benefit.

tion is to provide him or her with additional current compensation, through increased salary and/or a bonus. For income tax purposes, however, this technique generally only results in a tax wash, because the employee must include the full amount in income, with the company getting a corresponding deduction (to the extent the reasonable compensation test, discussed below, is met). It also results in additional employment and payroll taxes.

However, many situations can dictate payment of additional compensation to a key employee. For example, the employee may have net operating losses (NOLs), tax credits or charitable deductions that could absorb additional income. Or, the employee may have incurred unusually high deductible losses or expenses for the tax year in question that, because of the Sec. 172(d) limits on NOLs, cannot be carried over to other years.

If the only question is whether to receive additional taxable compensation currently or defer it, the employee and his or her tax adviser should closely analyze the possibilities. They should determine whether the employee would be in a better position on an after-tax basis if the proposed amounts were currently received and the after-tax proceeds invested, or deferred through a nonqualified deferral arrangement (discussed below). Any advice to defer or currently receive additional compensation should take into account factors such as the employee's age, marital status, attitude toward retirement planning and his or her ability to make constructive use of additional current compensation.[2]

The effects of the corporation's wealth retention, in lieu of paying additional compensation, should also be considered. The use of a C corporation employer as an income-splitting tool should not be overlooked in cases in which the business expects to generate a small amount of income. If the entity is not a professional corporation (subject to flat 35% tax) and is not at risk for incurring the Sec. 531 accumulated earnings tax, it should consider the benefit of retaining wealth in a low marginally taxed C corporation owned by a high marginally taxed shareholder-employee. Although the lower-taxed corporate retained earnings may someday be subject to double taxation, the present-value tax savings may more than overcome that risk. The Jobs and Growth Tax Relief Reconciliation Act of 2003 changes to Sec. 1(h), lowering the effective tax rate on long-term capital gains and qualified dividends to 15%, will further encourage this type of use of C corporations.

Reasonableness of Compensation

Reasonableness is a critical factor, not only for additional current compensation, but also for all the other benefits analyzed in this article. To be deductible by an employer as compensation expense, the total of all compensation to or for the benefit of an employee (both regular compensation and other benefits) must be reasonable for personal services actually rendered, as well as ordinary and necessary.[3] The tax adviser should keep this in mind when analyzing any specific benefit that may be provided to key employees on a discriminatory and deductible basis.

Reasonableness of compensation is a facts-and-circumstances, case-by-case determination; the major factors are fairly well established. Under Regs. Sec. 1.162-7 and -9, the determination should include the actual objective reasonableness of the amounts paid, whether such payments are made solely for services rendered and whether any amounts considered excessive would be proportionate to the stockholdings of the shareholder-

EXECUTIVE SUMMARY

- **There are many situations in which payment of additional salary and bonus to a key employee is warranted; the employee and tax adviser should carefully analyze the possibilities.**
- **Interest-free loans may be used in the compensatory context, despite restrictions and imputed interest under Sec. 7872.**
- **An employer-provided health plan can benefit both an employer and employee when premiums are deductible and proceeds are nontaxable.**

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[2] An excellent tool for doing a present-value analysis of these alternate scenarios is available at www.personal.kent.edu/~aagarwal/dca.html.

[3] See Sec. 162(a)(1) and Rev. Rul. 67-341, 1967-2 CB 156.

employees. Bonuses, if reasonable, will be deductible under the same rules as additional salary.

Cases: The cases are more illuminating as to the relevant factors in determining reasonable compensation. *Mayson Mfg. Co.*[4] is particularly significant, because the factors considered are almost identical to those set forth by the IRS in its audit manual.[5] *Mayson* emphasized the following factors: the employee's particular qualifications for the job; the nature, scope and extent of the work actually performed; the size and complexity of the particular business enterprise; the economic conditions and background of the industry involved; the particular company's dividend history; comparable salaries in the industry; the compensation paid to the company's other employees and the employee's prior-years' compensation (especially for years in which the key employee was clearly undercompensated). The reasonable compensation test is a cumulative one, focusing on all years in which the employee rendered services to the employer.[6] All of these factors should be researched and analyzed, without giving undue weight to any of them.[7]

If the taxpayer is a professional C corporation, a recent Tax Court case, *Pediatric Surgical Associates*,[8] has special relevance. The court's holding has caused great concern to tax advisers and has been roundly criticized. The court essentially found that compensation paid to shareholder-employees, but attributable to the services of nonshareholder-employees, is unreasonable and a dividend. This holding, if correct, would throw a major obstruction into typical professional corporation compensation schemes in which the younger professionals' services generate more company revenue than they are paid, with the excess being used to provide greater compensation to shareholders-employees than the revenue the latter group's actual services have generated. The court noted that the deduction requires evidence of valuable services justifying the level of compensation.[9] Similarly, other courts have held that no compensation deduction is allowed for a payment (1) really for a stock redemption[10] or (2) other than for services rendered.[11]

Even if additional current compensation payments are reasonable, they might not be currently deductible if the services were rendered incident to a capital improvement or construction. In such case, the compensation must be capitalized under Sec. 263(a) and added to the underlying asset's basis.

Interest-Free Loans

Despite the restrictions and imputed-interest rules under Sec. 7872, interest-free loans may still be cautiously used in a compensatory context. Under such an arrangement, the company, in a properly documented transaction, lends money at a below-market interest rate to a key employee. The employee must fully intend to pay back the amount borrowed.[12]

Prior to the Deficit Reduction Act of 1984 (DRA) (which implemented the imputed-interest rules) the question was whether the interest-free use of company funds constituted taxable income to the loan recipient. In a long line of cases, starting with *Dean*[13] in 1961, the courts have held that, generally, the interest-free use of a controlled corporation's funds by one of its owner-employees is not taxable income to the recipient. The general rationale is that if compensation was imputed to the employee-borrower, an offsetting deemed interest expense payment (and corresponding deduction) would also be infused into the transaction, producing a wash.

Concurring and dissenting judges in many of the *Dean* line of cases found flaws and inconsistencies in the tax wash concept. For example, if the employee-borrower did not itemize deductions, all or a part of the deemed interest expense would not be deductible and the *Dean* analysis would break down. Also, an interest deduction depends on the use of the loan proceeds.

Now, under Sec. 7872, the forgone interest on an interest-free or below-market loan to an employee is compensation income to the employee-borrower. He or she is treated as both receiving the amount of forgone interest as compensation income and repaying that amount as interest to the lender. The employer-lender ideally would be deemed to have paid the forgone interest as additional compensation to the employee and to have received the interest income. Subject to the reasonable compensation limit, the deemed payment of compensation would be fully deductible by the company.

Deducting Interest

The employee's deduction of such interest is subject to the usual limits

[4] *Mayson Mfg. Co.*, 178 F2d 115 (6th Cir. 1949).

[5] See *Internal Revenue Manual* Section 4.35.2.5.2.2 (3/1/02).

[6] See, e.g., *Henry Shotmeyer*, TC Memo 1980-238.

[7] See, e.g., *Elliots, Inc.*, 716 F2d 1241 (9th Cir. 1983).

[8] *Pediatric Surgical Associates, P.C.*, TC Memo 2001-81.

[9] See *Roth Properties, Co.*, TC Memo 1974-23, aff'd, 511 F2d 526 (6th Cir. 1975) ($1,250 paid to officer of corporation disallowed in full when the value of services were found to be *de minimis*).

[10] Compare *American Int'l Coal Co.*, TC Memo 1982-204 (redemption), with *Muskogee Radiological Group, Inc.*, TC Memo 1978-490 (compensation, not goodwill). See also *Ted N. Steffen*, 69 TC 1049 (1978); and *Synanon Church*, TC Memo 1989-270.

[11] See *C.H. Robinson, Inc.*, TC Memo 1998-430.

[12] If the loan transaction involves an owner-employee and is not properly documented, and/or the Service can show that there was no intent on the employee's part to repay the "loan" proceeds, the transaction could be recast as a dividend or compensation; see generally, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (Warren, Gorham & Lamont, 7th ed., 2002) at ¶8.05[6].

[13] *J. Simpson Dean*, 35 TC 1083 (1961); see also *Haworth H. Parks*, 686 F2d 408 (6th Cir. 1982); *Herman M. Greenspun*, 670 F2d 123 (9th Cir. 1982); *Colin F. Beaton*, 664 F2d 315 (1st Cir. 1981); *Albert Suttle*, 625 F2d 1127 (4th Cir. 1980); *William G. Martin*, 649 F2d 1133 (5th Cir. 1981); and *W.L. Hardee*, 708 F2d 771 (Fed. Cir. 1983).

and restrictions on interest deductibility. For example, at the same time, the employee is deemed to have received the same amount in income and to have paid it as interest expense back to the company. If the borrowed funds are traceable to property held for investment, the interest expense is deductible under Sec. 163(d), to the extent of net investment income, as an itemized deduction. Thus, if the amount of the forgone interest is reasonable and the employee can use the deduction, an income tax (but not employment tax) wash occurs to the company and the employee. Under Sec. 7872(f)(9), the parties must account for these deemed transactions for Form W-2, and FICA and FUTA (but not for income tax withholding) purposes as if they really occurred. Additionally, a $10,000 *de minimis* exception may apply under Sec. 7872(c) to exempt the overall transaction if its principal purpose is not tax avoidance.

It is not always clear whether a loan to a shareholder-employee is a compensation-related loan, or a corporation-shareholder loan, the imputed interest on which would be characterized as a nondeductible dividend. However, the legislative history to DRA Section 172 states, "the deemed transfer by a lender to the borrower is treated as a gift, a payment of compensation, a dividend, a contribution to capital, or some other payment depending on the substance of the transaction." Prop. Regs. Sec. 1.7872-4(d)(2) provides that a below-market loan from a nonpublicly held corporation to a greater-than-5% shareholder is presumed to be a corporation-shareholder loan, absent "clear and convincing evidence" that it is compensation related. The employer is well advised to thoroughly document the loan's compensatory nature in the corporate record book and loan documents and have factual documentation to support that form.

Insured Health and Hospitalization Plans

An employer-provided insured health and hospitalization plan is a group insurance plan in which the employer pays all or most of the premiums. For the benefits to apply, the plan needs to be fully insured (i.e., there can be no employer self-insured portion); otherwise, the anti-discrimination rules provided in Sec. 105(h) and Regs. Sec. 1.105-11(c) apply. Under Regs. Sec. 1.105-11(b)(1)(ii), the insured plan must involve classic insurance shifting of risk to an unrelated third party (e.g., the insurer).[14] If the plan is fully insured, the potential to discriminate as to participation (described below) would exist even if the employees contributed to the cost of coverage. However, if such employee contributions were provided on a pre-tax basis through a cafeteria plan, Sec. 125's strict nondiscrimination rules would apply.

This type of insured benefit falls into the ideal tax planning category: the employer gets a current deduction for its premium cost, while the benefited employee includes nothing in income, either when the premium payment is made or when health or hospital benefits are received from (or reimbursed by) the insurance company.

Premiums

Under Regs. Sec. 1.162-10, amounts paid by an employer for premiums on health or hospitalization coverage for its employees, together with all other compensatory benefits, must be reasonable to be deductible. Employer-paid premiums are generally excluded from an employee's gross income, under Sec. 106. This exclusion is conditioned on the employer paying the premium for coverage under an accident or health "plan." Under Regs. Sec. 1.105-5(a), such a "plan," within the meaning of Sec. 106, need not be in writing; however, prudence dictates that any fringe benefit plan should be well documented. Further, if more than one owner-employee is covered under such a plan, it would constitute a welfare benefit arrangement under the Employee Retirement Income Security Act of 1974 (ERISA) and would have to meet the ERISA Title I requirements, including the requirement that the plan be in writing.

The plan must be for the employees' benefit (i.e., common-law employees, not self-employed workers). Under Regs. Sec. 1.106-1, this term may include the employees' spouses and dependents (as defined in Sec. 152). Additionally, retired employees and their dependents, as well as the ex-dependents of a deceased employee, may obtain the exclusions afforded by Secs. 106 and 105 (discussed below).[15]

Lastly, to be excluded under Sec. 106, the plan must reimburse covered employees for personal injuries or sickness. Regs. Sec. 1.105-4(g) specifies that "personal injury" and "sickness" include any general injuries or illnesses.[16] It appears that premiums paid on an accidental death insurance contract are also excludible contributions for a plan compensating personal injury or sickness.[17]

Receipt of Benefits

In addition to employer-paid premiums, the employee's (and his or her covered spouse's and dependent's) receipt of benefits or reimbursements for medical care provided under a plan is excluded from

[14] Regs. Sec. 1.105-11(g) provides that reimbursements paid under a plan for medical diagnostic procedures for an employee (but not for a dependent) are not deemed to be part of a plan for purposes of the Sec. 105(h) nondiscrimination requirements.

[15] See Rev. Rul. 82-196, 1982-2 CB 53.

[16] See Rev. Rul. 74-542, 1974-2 CB 36.

[17] See Regs. Sec. 1.79-1(f)(3).

income under Sec. 105(b). To be excluded, Regs. Sec. 1.105-2 provides that payments for medical care must be received directly or indirectly by the covered employee; however, payments made to reimburse a covered employee for amounts deducted as medical expenses under Sec. 213 in a previous tax year must be included in the recipient's gross income under general Sec. 111 tax-benefit-rule concepts.

Shareholder Coverage

As was noted, there are no statutory or regulatory nondiscrimination requirements for insured health and disability plans maintained *for employees*. However, in the context of closely held corporations, the IRS will scrutinize any plan to determine whether it is maintained for and benefits owners in their roles as shareholders rather than as employees.[18] A plan that does benefit shareholders, instead of employees, is not "for employees" and will be deemed a constructive dividend. In such case, the company will get no deduction for its payments and the shareholder will have to report the full premium cost as dividend income to the extent of the corporation's earnings and profits.[19]

Shareholders can be covered by a company plan on a tax-favored basis only if there is a rational basis (other than ownership of the business) to justify their benefits (i.e., they are bona fide employees of the company (or spouses or dependents of such employees)). This rational basis exists when the employees covered include key employees and their families,[20] all officer-employees and their families[21] or all employees.[22] For small companies in which all employees are also shareholders and officers, the plan will clearly qualify if it complies with the above requirements. A sole shareholder-sole employee plan will comply if the plan benefits the employee as an employee and not as sole shareholder. In these cases, a written plan takes on added significance.[23] Covering only (or primarily) retired shareholders or nonactive employees is problematic.[24]

State law: The tax adviser should also be concerned with state law. For example, Ohio Rev. Code Section 3724, which applies to Ohio companies employing more than two but fewer than 50 employees, requires an employer to provide all regular employees the same insured health benefits given to highly compensated employees (HCEs), but allows for premium cost-shifting (i.e., the company can pay for the HCEs' coverage, while requiring lower-compensated employees to contribute toward the premium).

Employer-Provided Disability Insurance

Under Sec. 106, premium payments by an employer for an employer-provided disability income contract are excluded from the employees' gross income. However, any payments to a disabled individual from an employer-provided disability income contract for lost wages must be included in the disabled employee's gross income.[25] Such payments cannot be excluded under Sec. 105(b), as they do not meet Sec. 213(d)'s definition of payments for medical care.

Sec. 105(c) provides an exclusion from gross income for employer-provided contracts if the disability payment is made to compensate the employee for permanent loss of a bodily member or function or for permanent disfigurement. To qualify, payments must be computed by reference to the injury, without regard to absence from work, and must not otherwise act as a substitute for lost wages.

However, if a disability income contract is bought and paid for by an individual, rather than his or her employer, any payments received under the contract *will* be excludible from the recipient's income under Sec. 104(a)(3). Because of this distinction, the owner-employee of a closely held corporation might favor nondeductible[26] employee-paid disability premiums, forgoing a current employee exclusion (and corporate deduction)[27] in return for total exclusion of the disability payments. While employer-provided coverage allows current deductibility for the employer-paid premiums and no inclusion of the premium cost in the covered employee's gross income under Sec. 106, future inclusion of disability payments in gross income might be perceived as a strong tax disincentive to such an arrangement. The current marginal tax brackets of both the employer and the key employee, as well as the employee's anticipated future marginal rates, should be reviewed to determine which option provides the best overall tax results.

Conclusion

Part II, in the November 2004 issue, will discuss other methods for selectively compensating key employees of closely held C corporations on a tax-favored basis, such as group life insurance, split-dollar life insurance and nonqualified deferred compensation.

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[18] See *Marcus Wiguton*, TC Memo 1983-620.
[19] See *Samuel Levine*, 50 TC 422 (1968); and *Alan B. Larkin*, 394 F2d 494 (1st Cir. 1968).
[20] *Bogene, Inc.*, TC Memo 1968-147.
[21] *Nathan Epstein*, TC Memo 1972-53 and *E.B. Smith*, TC Memo 1970-243.
[22] *Arthur R. Seidel*, TC Memo 1971-238.
[23] See *Wiguton*, note 18 supra.
[24] See *America Foundry*, 536 F2d 289 (9th Cir. 1976); and *Sturgill Motor Co.*, TC Memo 1973-281.
[25] See *Asa Pearson*, TC Memo 2000-160.
[26] See Sec. 213(d)(1).
[27] The employee is precluded from deducting disability insurance premiums that he or she paid personally; see Sec. 213(d)(1)(D).