

## TAX BRIEFS

### Introduction:

As we near year-end, two recent rulings – one by the U.S. Tax Court and one by the IRS – remind us of some tax basics to keep in mind.

### Excessive Compensation Turns Into Instructive Dividends:

To be deductible for income tax purposes, claimed compensation must be both reasonable in amount and paid. If the IRS determines that claimed compensation was unreasonably high, the IRS may recharacterize some part of what was deducted as “compensation” by the corporation as a dividend paid to shareholders. A dividend is not deductible for income tax purposes.

Sometimes it is assumed that if a corporation specifies an incentive or bonus formula at the beginning of the tax year – a percentage of gross revenues, net revenues, profits, or the like – a payment pursuant to that formula will be reasonable *per se*.

This last point was what John Menard banked on when his bonus was set at 5% of Menard, Inc. (“Menard’s”) net income before taxes for Menard’s tax year ending in 1998. The resulting bonus of \$17,467,800 was added to his salary of \$157,500 plus \$3,017,100 in profit sharing under a company-wide plan, resulting in total compensation paid to Mr. Menard for that year of \$20,642,585. Menard’s deducted that amount as a business expense on its 1998 tax return.

But the IRS and Tax Court thought differently. First, the Tax Court found that Mr. Menard’s total compensation was unreasonably high in amount. After significant analysis - including “dueling experts” and comparing Mr. Menard’s salary to the salary of the head of Target, Lowe’s and other companies - the Tax Court determined that only \$7,066,912 represented reasonable compensation to Mr. Menard for the year in question.

Hold on, argued Mr. Menard. Most of his compensation came from the 5% bonus, which was so large only because Menard’s was so successful for the year, because of Mr. Menard’s own efforts.



The Tax Court disagreed and concluded much of that 5% bonus was not compensation, but a dividend. In reaching its conclusion, the Tax Court reminded us of six factors that indicate when ostensible “compensation” is a disguised dividend (hence, not deductible to the corporation):

1. Bonus is paid in exact proportion to officers’ shareholdings;
2. Payments are made in lump sums (typically at or near year-end) rather than as services are rendered;
3. An absence of formal dividend distribution by a growing corporation;
4. A completely unstructured bonus system, lacking relation between payment amount and services performed;
5. Consistently negligible taxable corporate income; and
6. Bonus payments made only to officers who are also shareholders.

Not all six factors were present with respect to Mr. Menard’s compensation – he was not the only shareholder, although possibly the only one to get a bonus, and it is not clear that Menard’s consistently had only negligible taxable income. But the Tax Court determined that sufficient factors were present to indicate that a large part of Mr. Menard’s ostensible “compensation” was, in fact, a dividend (taxable to Mr. Menard but not deductible to Menard’s).

The result was Menard's lost a tax deduction for about \$13 million, but Mr. Menard was taxable on all of the approximately \$20 billion that he received. Menard, Inc. v. Commissioner, Tax Court Memorandum decision 2004-2007, September 16, 2004. (It is not known if this decision is on appeal.)

The Menard case was one of a C (or "regular") corporation being denied a deduction for excessive compensation, and having the excessive compensation re-characterized as a dividend to a shareholder. Exactly the opposite situation sometimes arises with closely held S corporations with shareholder employees. Sometimes an S corporation shareholder-employee will claim very little of what is paid to her or him by the corporation if compensation is for services. Rather, the corporation claims, most, if not all, of what is paid is an S corporation distribution. The S Corporation shareholders pay taxes on all of the corporate income anyway. But compensation is subject to Social Security and Medicare tax, while corporate distributions are not. Essentially, the same "reasonableness" standard applies in this setting – unreasonably low compensation can in the S corporation setting be just as subject to IRS challenge as unreasonably high compensation in the C corporation setting.

### **Holiday Gift Certificates: IRS = Grinch? You decide.**

An employer provided holiday gift coupons to employees. The coupons had a face value of \$35. The coupons were redeemable at several local grocery stores. The coupons could be used only once, and any unused portion would be forfeited (no "cash-out" option). The coupons had to be redeemed between November 15 and January 31.

The employer previously gave employees a ham, turkey or gift basket as an annual holiday gift. But employees of certain religious convictions, and employees with certain dietary limitations, requested gift coupons instead so that they might select their own holiday fare consistent with those convictions and limitations. The employer obliged. The IRS did not.

The IRS viewed the gift coupons as a cash equivalent fringe benefit such as a gift certificate. The IRS stated that it was administratively practicable to account for the gift coupons, at a value of \$35 each. Accordingly, the gift coupons were not excludable from the employees' gross income. As a consequence, each

employee who received a gift coupon had an extra \$35 in wage income to be reported on his or her W-2 for the year.

Many had thought – and the employer argued – that a gift coupon not redeemable in cash would not be considered gross income to the employee. After all, the gift of an actual ham or turkey at a holiday has not been considered gross income. The IRS disagrees; the only question is whether it is administratively practicable to determine the value of the gift, which always will be true with a "face-value" gift coupon or a gift certificate. The employer also argued that gifts with a value of \$75 or less should be considered *de minimis*, since for purposes of substantiating employee business expenses, employees need not (at least under IRS rules) submit receipts for expenses of less than \$75. The IRS simply did not accept that argument.

If you are considering gift certificates or "gift coupons," in connection with the holidays (or just as a reward for extra effort), know that the IRS view is that the value must be included in the employee's W-2 income.

IRS Technical Advisor Memorandum 200437030, September 10, 2004. If you have any questions, please contact Tom Doyle of our St. Paul Office or Pat Brinkman of our Minneapolis office.



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# ANNUAL CHECKLIST FOR BUSINESS ENTITIES

Year-end is an appropriate time to consider all of the significant events that have occurred in your business during the past year and to plan for the upcoming year. It is important for all forms of business entities to maintain up-to-date minutes of material activities taken by the business. The following events are examples of the types of events that may require the approval of the Board of Directors (or Board of Governors, for limited liability companies) and/or shareholders (or members, for LLCs) that should be documented in the minutes of the business entity:

- ✓ A change in the name of the entity
- ✓ A change in the registered address of entity change in the principal place of business of the entity
- ✓ A change in the fiscal year of the entity
- ✓ A change in the number or identity of directors (or governors, in the case of an LLC)
- ✓ A change in the number or identity of officers
- ✓ The issuance of stock (or membership interests, in the case of an LLC)
- ✓ Entering into any buy-sell or other stock redemption or purchase agreement
- ✓ Entering into any merger or acquisition documents with other entities
- ✓ Becoming a partner in any partnership or a member in any limited liability company
- ✓ Amending Articles, Bylaws or Operating Agreement, as applicable
- ✓ Opening a new bank account (checking or savings)
- ✓ Payment of bonuses to officers or other employees
- ✓ Purchase of life insurance or disability insurance by entity
- ✓ Adoption of group term life insurance or medical insurance plan
- ✓ Adoption of other benefits for officers and/or directors (or governors)
- ✓ Making contributions to benefits plans

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- ✓ Borrowing of money
- ✓ Loans to or from directors (or governors), officers or employees
- ✓ Sale, purchase, lease, exchange or encumbrance of significant assets not in the ordinary course of the entity's business
- ✓ Entering into an Employment Agreement, Management Agreement, Consulting Agreement, etc.

In addition to keeping up-to-date minutes, be sure to file the annual registration for the entity with the Minnesota Secretary of State. On-line filing is now available, and additional information is available on the Secretary of State's website, <http://www.sos.state.mn.us/>. If you have any questions regarding the preparation of appropriate resolutions to be included in the minutes of your business or the filing of the annual registration, please contact Karen Ciegler Hansen or Trina Sjoberg in the business section.

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## Business Report

*The Business Report is an update on legal developments. It is not intended to be legal advice and should not be relied upon without consulting counsel.*

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