

I.R.C. Section 162(a)(1) and the Professional Corporation: Compensation Versus Dividends

W. Gary Hull

As an employee, a person rendering services to a corporate employer receives remuneration from the employer in the form of "compensation."¹ Generally, these payments constitute ordinary income to the employee² and a deductible ordinary business expense to the corporation.³ On the other hand, shareholders of the same corporation will generally receive a return on their investment in the form of "dividends" payable out of the corporation's earnings and profits.⁴ These payments constitute ordinary income to the shareholder,⁵ but are not generally deductible by the corporation.⁶ Thus, corporate earnings and profits distributed to the shareholder as dividends are subject to so-called "double taxation."⁷

In the case of a professional corporation (P.C.)⁸ a conflict between

1. The word "compensation" will be used in this Note to include "all forms of remuneration, including deferred compensation, contributions to employee benefit plans, fringe benefits and other similar types of non-cash payments." See Grigsby & Reed, *How to Establish that Full Compensation Paid to a Shareholder-Employee is Deductible*, 24 TAX FOR ACCT. 210, 210 (1980).

2. I.R.C. § 61 (1982) provides in part:

(a) General Definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, . . .

. . . .

(7) Dividends;

3. I.R.C. § 162(a)(1) (1982). This section provides in part:

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered

Id.

4. For purposes of federal income taxation, dividends are defined at I.R.C. § 316 (1982).

5. I.R.C. § 61(a)(7) (1982). For the text of this provision, see *supra* note 2.

6. I.R.C. § 311(a) (1982).

7. See generally Swift, *Reasonable Compensation, A Question of Fact*, 52 A.B.A. J. 384 (1966). The term "double taxation" refers to the fact that since dividends are not deductible by the corporation (as are compensation payments), income to the extent of such dividends is taxed first at the corporate level and again to the shareholder upon his receipt of the dividend. *Id.* at 384, n.2.

8. Every state has professional corporation statutes. Chasman, *Professional Corporations*, in *ADVANCED ESTATE PLANNING READINGS* 9.9 (S. Leimberg ed. 1980). In Arizona see ARIZ. REV. STAT. ANN. §§ 10-901 to -909 (1977).

dividend and compensation treatment can occur.⁹ Because the shareholders of a P.C. are generally active employees of the same corporation,¹⁰ the P.C. can avoid the double taxation effect of dividends to the extent its earnings are paid to the employee-shareholders in the form of deductible compensation.¹¹ Recently, this tactic has come under closer scrutiny by the Internal Revenue Service (Service) in cases where the P.C., whose income is solely attributable to the services of its employee-shareholders, has paid out all or most of its earnings to the employee-shareholders in the form of compensation to the exclusion of any dividends.¹²

The basis for such scrutiny is Treasury Regulation section 1.162-7¹³ which accompanies section 162(a)(1) of the Internal Revenue Code (I.R.C.).¹⁴ This regulation requires that compensation payments be both reasonable in amount and purely in return for services to be deductible.¹⁵ To the extent the payments fail to meet either of these tests, the Service will reclassify the payments as dividends,¹⁶ resulting in double taxation. While the change in classification is not critical to the employee-shareholder,¹⁷ it can have serious consequences to the P.C.¹⁸

9. See generally Rosenbaum, *The Court of Claims Holding on a Legal PC's Reasonable Compensation: Problems Remain*, 55 J. OF TAX'N 138 (1981) (discusses whether payments made to an employee-shareholder of a P.C. should be characterized as compensation to the individual in his employee capacity or dividends in his shareholder capacity).

10. In Arizona, see ARIZ. REV. STAT. ANN. § 10-908 (1977) which provides in part: "A professional corporation shall . . . [b]e formed by one or more persons licensed to render the same category of professional service with the object and purpose of engaging in the practice of such profession and rendering such professional service and dividing the gains therefrom."

11. See *supra* note 7.

12. See Isaacson, Rosenbaum, Spiegelman & Friedman, *P.C. v. United States*, 79-2 U.S. Tax Cas. (CCH) 87695 (Ct. Cl. 1979), for an example of such scrutiny. See also Rosenbaum, *supra* note 9.

As a general proposition, the Service and the courts have historically applied close scrutiny to payments made by close corporations to employee-shareholders. Charles Schneider & Co. v. Comm'r, 500 F.2d 148, 152 (8th Cir. 1974), cert. denied, 420 U.S. 908 (1975); Logan Lumber Co. v. Comm'r, 365 F.2d 846, 851 (5th Cir. 1966); Irby Constr. Co. v. United States, 290 F.2d 824, 826 (Ct. Cl. 1961).

13. Treas. Reg. § 1.162-7 (1958).

14. I.R.C. § 162(a)(1) (1982). See *supra* note 3 for the text of this provision.

15. Treas. Reg. § 1.162-7(a) (1958). See *infra* notes 23-32 and accompanying text.

16. Treas. Reg. § 1.162-7(b)(1) (1958) states in part:

Any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.

17. To the employee-shareholder, the distinction is not critical since both compensation and dividends constitute gross income. I.R.C. § 61 (1982). In addition, pursuant to the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (West Supp. 1982) (ERTA) both forms of payment yield essentially the same tax result to the individual. Prior to ERTA, I.R.C. § 1348 provided that earned income was subject to a maximum tax rate of 50% while the maximum rate on dividends was 70%. However, pursuant to ERTA, the maximum tax rate for individuals has been lowered to 50% for all types of income. I.R.C. § 1 (1982). Therefore, § 1348 is no longer necessary and was repealed effective January 1, 1982 by section 101 of ERTA. The only current distinction is that the individual receives a \$100 exclusion (\$200 in the case of a joint return) for dividends received from domestic corporations. I.R.C. § 116 (1982).

18. See *supra* notes 3, 6 & 7 and accompanying text.

Since the courts have not decided whether a P.C. can totally avoid dividend payments,¹⁹ this Note will examine the issue, giving consideration to professional law corporations. First, the two prongs of Treasury Regulation section 1.162-7 will be summarized, including the factors typically considered in determining their compliance. These two prongs provide the test for determining the deductibility of payments to employee-shareholders under section 162. Second, the current interpretations of section 162(a)(1) and the regulations thereunder will be reviewed and analyzed with respect to their potential application to professional corporations. Third, the question of whether special considerations—in the form of exceptions to the rules as generally applied—should be afforded P.C.'s will be discussed. Finally, a suggested application of section 162(a)(1) to the professional corporation will be proposed.

The Two-Pronged Deductibility Test of Section 162(a)(1)

The predecessor of section 162(a)(1) of the Internal Revenue Code was first enacted in 1918.²⁰ Early commentators concluded that the reasonable compensation provision was not designed to limit deductibility of compensation. Instead, they felt it was intended to allow a deduction for compensation even though no compensation had actually been paid.²¹ The courts, however, have consistently interpreted the reasonable compensation provision as a restriction on the deductibility of compensation.²² Consistent with this interpretation, Treasury Regulation section 1.162-7(a)²³ establishes a two-pronged test to determine the deductibility of compensation payments: (1) the payments must be reasonable; and (2) the

19. See generally *Petro-Chem Mktg. Co. v. United States*, 602 F.2d 959, 967 (Ct. Cl. 1979) (court stated the determination of such a "novel" issue is left for an appropriate case); Rosenbaum, *supra* note 9 at 140-41. The problem is compounded by the fact that it is impossible to get an advance ruling on the reasonableness of compensation under section 162. Rev. Proc. 62-32, 1962-2 C.B. 527.

20. Revenue Act of 1918, ch. 18, § 234(a), 40 Stat. 1077 (1919).

21. Griswold, *New Light on "A Reasonable Allowance for Salaries,"* 59 HARV. L. REV. 286 (1945). For a good summary of the argument, see Comment, *Updating the McCandless Doctrine: Taxing of Reasonable Compensation Paid by Closely-Held Corporations*, 12 JOHN MARSHALL J. OF PRAC. & PROC. 113, 113 n.4 (1978).

22. *Home Interiors & Gifts, Inc. v. Comm'r*, 73 T.C. 1142, 1155 (1980). There the court stated:

In 1943, Dean Griswold sought to discover the purpose of the [reasonable compensation] provision. He found that there was a dearth of legislative history illuminating its purpose; he concluded that the legislative objective was to enact the limitations which had appeared in the Treasury regulations denying a deduction for payments which were in effect dividends or gifts to shareholders or their relatives. However, later research led Dean Griswold to a different conclusion: He found that the language of the 1918 Act was similar to the language of earlier excess profits tax regulations and that such language had been included in such regulations to allow a deduction for reasonable compensation for officers even though no such compensation was actually paid. Thus, he concluded that the provision was not designed as a limitation on the deductibility of compensation. Despite Dean Griswold's research, the law has developed otherwise. The reasonable compensation provision has uniformly been considered by the courts to be a restriction on the deductibility of compensation; nevertheless, Dean Griswold's research helps to point the way in deciding the scope of the restriction.

Id. (citations omitted).

23. Treas. Reg. § 1.162-7(a) (1958).

payments must be in fact purely for services.²⁴ To the extent alleged compensation payments satisfy both of these prongs they will be deductible as ordinary business expenses under section 162(a)(1). There is extensive case law interpreting the meaning of "reasonable" under this test, describing the many factors to be taken into consideration.²⁵ These factors include: (1) the compensation paid to the individual as compared to the value of the services performed; (2) the salary history of the employee; (3) the salary scales for both the company and industry in general; and (4) the qualifications of the employee and his contribution to the success of the business.²⁶ Where an employee-shareholder of a P.C. receives compensation less than or equal to the fees he billed during the year for his services, the reasonableness prong presents few problems.²⁷

24. *Id.* This provision provides:

There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. *The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.*

Id. (emphasis added). This two-pronged test has been included in the Treasury Department regulations since 1918. [1974] 202 TAX MGMT. (BNA) A-2 (3d ed.).

25. See generally cases cited at [1974] 202 TAX MGMT. (BNA) C-3 (3d ed.). Factors generally considered include:

[T]he employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.

Mayson Mfg. Co. v. Comm'r, 178 F.2d 115, 119 (6th Cir. 1949).

This Note does not deal with the first prong (reasonableness) since there are already numerous articles dealing with the topic. See, e.g., Ford & Page, *Reasonable Compensation: Continuous Controversy*, 5 J. CORP. TAX'N 307 (Winter 1979); Grigsby & Reed, *supra* note 1; Hoffman, *Heading Significant Factors Improves the Odds for "Reasonable" Compensation*, 50 J. TAX'N 150 (March 1979). Also, in the context of a P.C., reasonableness is not the critical issue. See *infra* note 27 and accompanying text.

26. [1974] 202 TAX MGMT. (BNA) A-7 to -10 (3d ed.).

27. See *Klamath Medical Serv. Bureau v. Comm'r*, 29 T.C. 339 (1957) (payments to the doctor-shareholders were reasonable in amount to the extent of 100% of their billings for medical services during the years in question), *aff'd* 261 F.2d 842 (9th Cir.), *cert. denied*, 359 U.S. 966 (1959).

Determining whether compensation is reasonable under § 162(a)(1) is a question of fact to be determined based on all the facts and circumstances of a case. See *Charles Schneider & Co. v. Comm'r*, 500 F.2d 148, 151 (8th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); *Pacific Grains, Inc. v. Comm'r*, 399 F.2d 603, 605 (9th Cir. 1968); *Mayson Mfg. Co. v. Comm'r*, 178 F.2d 115, 119 (6th Cir. 1949); *Hoffman Radio Corp. v. Comm'r*, 177 F.2d 264, 266 (9th Cir. 1949); *Miller Mfg. Co. v. Comm'r*, 149 F.2d 421, 423 (4th Cir. 1945). The burden of proof in this determination falls on the taxpayer. See *Botany Worsted Mills v. United States*, 278 U.S. 282, 293 (1929); *Griffin & Co. v. United States*, 389 F.2d 802, 810 (Ct. Cl. 1968); *Northlich, Stolley Inc. v. United States*, 368 F.2d 272, 277 (Ct. Cl. 1966); *R.J. Nicoll Co. v. Comm'r*, 59 T.C. 37, 48 (1972); *but see Skyland Oldsmobile, Inc.*, 31 T.C.M. (CCH) 47, 50 (1972) (taxpayer may provide competent testimony and evidence to show the Commissioner's determination to be erroneous, whereupon the commissioner's "presumption loses its effect and the Court must determine from all the evidence submitted what was reasonable compensation."). See *supra* note 25 for examples of factors considered. At one time, a finding that the compensation was reasonable in amount was sufficient in itself to satisfy the deductibility test of § 162(a)(1). *McLean & Martin, Is "Reasonable" Enough? The McCandless Doctrine*, 54 TAXES 642, 642 (1976). Many corporations, therefore, took advantage of this interpretation of § 162(a)(1). C. HALSEY & M. PELOUBET, *FEDERAL TAXATION AND UNREASONABLE COMPENSATION* 2 (1964). Dividends were reduced to little or nothing, while as much as possi-

Applying the second prong, however, does present a problem where the P.C. has consistently paid out all or most of its pre-salary profits to the employee-shareholders in the form of compensation for their services as opposed to dividends. When determining whether the payments were in fact purely for services, the inquiry narrows to whether the employee-shareholders should also have received any dividends in their shareholder capacities.

The key factors considered by courts in evaluating the purely for services prong, in the context of "regular" corporations, have been (1) the ratio of the compensation payments to the respective recipients' stockholdings,²⁸ and (2) the past dividend policy of the corporation.²⁹ To the extent that compensation payments coincide with each employee's shareholdings, it seems clear that the payments are not based solely upon the services performed by the employee-shareholders, but are to some extent based on the employees' respective shareholdings.³⁰ To that extent dividend treatment seems appropriate. The more crucial and controversial factor is the corporation's prior dividend history.³¹ The absence of prior dividends in a profitable corporation will clearly invite close scrutiny by the Service of the corporation's compensation deductions.³² And, where the corporation's profits are in part due to the investment of capital as opposed to the services of its employee-shareholders, this scrutiny appears well justified. When applied to a P.C. whose income is collected through fees for the services of its employee-shareholders, however, the logic is not so apparent. It is the application of this factor—the absence of prior dividends—to P.C.'s that is the primary topic of this Note.

The "Automatic Dividend Rule"

Among the federal jurisdictions,³³ various interpretations of the "purely for services" test of section 162 have evolved. The Court of Claims' interpretation, in particular, has proven to be the most restrictive. The Court of Claims held in *Charles McCandless Tile Service v. United States*³⁴ that while alleged compensation payments may be reasonable in

ble was distributed in the form of deductible compensation. *Id.* For this reason the Service has devoted much attention to the deductibility of alleged compensation payments in the case of closely held corporations. *Id.*

28. Ford & Page, *supra* note 25, at 319.

29. *Id.* at 317. For a similar discussion of the key factors to consider, see [1974] 202 TAX MGMT. (BNA) A-7 to -10 (3d ed.).

30. See Ford & Page, *supra* note 25, at 319-20.

31. *Id.* at 317. The proper weight to be given the presence or absence of dividend payments is the major topic of this Note. For example, compare the "automatic dividend rule" of the Court of Claims in *Charles McCandless Tile Serv. v. United States*, 422 F.2d 1336 (Ct. Cl. 1970) (discussed *infra* notes 34-44 and accompanying text) with the "intent" rule of the Tax Court, whereby absence of dividends is only one of many factors to be considered (discussed *infra* notes 75-92 and accompanying text).

32. See Ford & Page, *supra* note 25, at 317.

33. In federal income tax matters, taxpayers have the option of filing suit for refund in either the United States District Court or Court of Claims if the assessed deficiency has been paid. [1974] 202 TAX MGMT. (BNA) A-18 (3d ed.). If the taxpayer does not wish to pay the deficiency before filing suit, suit must be filed in the Tax Court to prove the reasonableness of the compensation payments. *Id.*

34. 422 F.2d 1336 (Ct. Cl. 1970).

amount,³⁵ an absence of dividend payments in a successful corporation indicates that the compensation payments "necessarily" contain a distribution of earnings and profits in the form of dividends.³⁶

The relevant facts of the *McCandless* case are simple. A ceramic tile contracting corporation was owned and operated by a father and son who shared ownership equally.³⁷ For the years in question (1963-65) the father and son were paid equal salaries totaling approximately fifty percent of net profits before salaries and federal income tax.³⁸ However, no dividends had been paid or declared since the corporation's inception in 1960.³⁹ After examining all the circumstances of the payments to the two shareholder-employees, the court held that the amounts paid in and of themselves were reasonable.⁴⁰ The court stated, however, that the mere reasonableness of the amounts was not dispositive of the issue of deductibility under section 162.⁴¹ Noting the absence of any dividends, the court explained that the absence of any return on equity capital was so conspicuous that under the circumstances the alleged compensation payments necessarily contained a distribution of earnings and profits in the form of dividends.⁴²

In other words, by choosing to operate through a corporate entity, the shareholders have established an investment for which they should receive an investment return (dividends) if the corporation is successful. A profitable corporation, therefore, should not be able to avoid payment of dividends to shareholder-employees by disbursing all the profits in the form of deductible compensation. The Court of Claims therein created an "automatic dividend rule"⁴³ whereby profitable corporations must pay dividends. In justifying this conclusion, the court reasoned that just as an employee deserves substantial compensation if he is responsible for the profit-making success of a corporation, the corporation's success also justifies a substantial investment return to its shareholders—whether they are also employees or not.⁴⁴

35. *Id.* at 1339.

36. *Id.* at 1339-40. The Court of Claims had held in an earlier case, in the context of a family corporation, that "the question of reasonableness of compensation is inseparably tied to the question of whether the alleged compensation is not really a dividend in disguise." *Irby Constr. Co. v. United States*, 290 F.2d 824, 826 (Ct. Cl. 1961). Further, "even a payment that is reasonable is not deductible if it was actually a distribution of earnings as contrasted with compensation for services rendered." *Id.* at 827.

37. 422 F.2d at 1337-38.

38. *Id.* at 1338. The court noted, however, that the salaries "were a lesser percentage of net profits than the national average for such special trade contractors." *Id.* at 1339.

39. *Id.* In addition, the court noted that "[w]hile plaintiff's retention of net profits (after salaries and Federal income taxes) during the years in issue appears to reflect conservative business policies of building up operating capital reserves, only a small percentage of such retained profits was actually utilized for capital expenditures." *Id.* at n.3.

40. *Id.* at 1339.

41. *Id.* The court stated that "[e]ven a payment deemed reasonable . . . is not deductible to the extent that it is in reality a distribution of corporate earnings and not compensation for services rendered." *Id.*

42. *Id.* at 1339-40.

43. The "automatic dividend" rule, alternatively known as the *McCandless* doctrine, was first coined as such in Holden, *Has the Court of Claims Adopted an Automatic Dividend Rule in Compensation Cases?*, 32 J. TAX'N 331, 331 (1970).

44. 422 F.2d at 1340.

In a more recent case, *Petro-Chem Marketing Co. v. United States*,⁴⁵ the Court of Claims reaffirmed the automatic dividend rule for cases factually similar to *McCandless*.⁴⁶ Petro-Chem was a family owned corporation with the father and two sons being the sole employees of the corporation.⁴⁷ The corporation operated as a broker in petro-chemicals.⁴⁸ After finding a willing buyer and seller for a particular petro-chemical, the corporation would purchase the chemical in its own name and resell at a profit to the prearranged buyer.⁴⁹ The corporation did not, however, maintain any inventory.⁵⁰ The success of the corporation was due in large part to the reputation of the father and his two sons in the industry.⁵¹ For the year in question, however, the corporation realized substantially increased profits due to the "chaotic conditions prevailing in the petro-chemical industry."⁵² Therefore, near the end of the year the three were able to grant themselves large bonuses leaving only enough in the corporation to meet current obligations.⁵³

The court concluded that the bonuses were, at least in part, a distribution of profits rather than compensation for services, despite finding that the payments may have been reasonable in amount.⁵⁴ In reaching this conclusion the court emphasized five key factors. First, Petro-Chem was a close corporation.⁵⁵ Therefore, the court applied careful scrutiny to the payments the employee-shareholders received.⁵⁶ Second, the corporation had never paid any dividends.⁵⁷ Third, the corporation's capitalization was very low in relation to its earnings and profits.⁵⁸ Fourth, the bonuses

45. 602 F.2d 959 (Ct. Cl. 1979).

46. The Court of Claims found the facts in *Petro-Chem* to be "remarkably similar to those in *McCandless*." *Id.* at 961.

47. *Id.* at 962. The company also employed a secretary and part-time bookkeeper. In addition to the father and two sons, the wife was also a shareholder, but played a passive role in the operations. *Id.*

48. *Id.* at 962-64.

49. *Id.* at 964.

The plaintiff did not have long-term contracts with either manufacturers or consumers. Rather, it engaged in a "spot" type of business that involved a succession of deals whereby the plaintiff would contract to purchase a specified quantity of a product from a petro-chemical manufacturer, and would separately contract to sell the same quantity to a consumer.

Id.

50. *Id.*

51. *Id.* at 964-65. The record indicated that their success was dependent largely upon their "reputation, personal contacts, and personal friendships among members of the petro-chemical industry." *Id.* at 964.

52. *Id.* at 967.

53. *Id.*

54. *Id.* at 968.

55. The term "close corporation" merely refers to the fact that the corporation had relatively few shareholders. See generally ARIZ. REV. STAT. ANN. § 10-203(A)(3) (1977) ("The number of original investors shall not exceed ten").

56. 602 F.2d at 961; see discussion *supra* note 12.

57. *Id.* The court did not explain the significance of this factor, citing no support, but did state at another point in the opinion that the facts were "remarkably similar to those in *McCandless*." *Id.* For this reason, many commentators have stated that the Court of Claims thus reaffirmed the automatic dividend rule in *Petro-Chem*. See, e.g., Ct. Cls. Again Invokes Automatic Dividend Rule, 8 TAX'N FOR LAW. 236, 237 (1979-80).

58. 602 F.2d at 961. "They would leave in the corporation only such sum as they regarded as constituting reasonable earnings on the modest amount of capital invested in the corporation, thus

exceeded the salaries and were computed near year-end when profits were accurately estimable.⁵⁹ Fifth, as in *McCandless*, the corporation failed to overcome its burden of proving that the payments were "purely for services."⁶⁰

Possibly more important than the Court of Claims' reaffirmation of the automatic dividend rule, however, was its effort to factually distinguish the corporation in *Petro-Chem* from a professional corporation. The Petro-Chem corporation suggested that the case presented the novel issue of whether a corporation which derived its profits solely from personal services performed by its employee-shareholders could pay out all its net profits to the employee-shareholders as compensation.⁶¹ The court, however, clearly disagreed.⁶² Not only was a significant portion of the corporation's profit attributable to chaotic conditions in the industry, as opposed to the skills of the employee-shareholders, but the corporation itself "bore a much greater resemblance to a broker of commodities than to an organization of doctors, lawyers, or engineers."⁶³ The apparent rationale for this distinction was that a broker relies on the sales of a product and its changing market fluctuations, as opposed to selling purely personal services. For these reasons, the court specifically reserved judgment, pending an appropriate case, on whether a P.C. incorporated under a state professional act could pay out compensation to the exclusion of dividends.⁶⁴

In Isaacson, Rosenbaum, Spiegleman & Friedman, P.C. v. United

providing a fund that would be available to pay bills and defray other obligations of the corporation." *Id.* at 967. While the court did not explain the significance of this factor upon its holding, presumably it relates to the corporation's nonpayment of dividends; not only had the corporation paid no dividends, but it had retained insufficient profits with which to declare dividends in the future.

59. *Id.* at 961. The court stated:

[I]n November of each year, when it was possible to determine with considerable accuracy the approximate amount of money that the [corporation] would make during the year, over and above the . . . salaries and the other expenses of the corporation, the [father and his two sons] would . . . discuss and determine how much of the available money should be paid to them by the [corporation] . . . and how much should be left in the corporation.

Id. at 967. The court did not discuss the significance of this finding, but cited *Ecco High Frequency Corp. v. Comm'r*, 167 F.2d 583 (2d Cir.), *cert. denied*, 335 U.S. 825 (1948). *Petro-Chem*, 602 F.2d at 968. In *Ecco*, the Second Circuit made a similar finding of fact in holding that only a portion of the alleged compensation payments made by the corporation were deductible. 167 F.2d at 585. The court stated: "[T]he amounts [the employee] received were determined at the close of each year when earnings could be ascertained, no dividends were paid to the shareholders . . . although it was Ecco's most successful year and the Tax Court found that [the employee] was in complete control of [the corporation]." *Id.* at 585.

60. *Petro-Chem*, 602 F.2d at 961. See *supra* note 27 for cases dealing with the burden of proof in such determinations.

61. *Petro-Chem*, 602 F.2d at 967.

62. *Id.* at 962, 967.

63. *Id.* at 962. The court also stated that:

The variations in volume of business and gross profit indicate rather convincingly that changing conditions in the market place were an important factor in establishing the level of the plaintiff's income in the various years, and that the plaintiff's profitability in 1973 (the year in issue) was not attributable *solely* to the personal services rendered by the father and son.

Id. at 968.

64. *Id.* at 962, 967. To date there has been no decision on this issue. See *supra* note 19 and accompanying text.

*States*⁶⁵ the Court of Claims had its first opportunity to decide the dividends versus compensation issue in the context of a P.C.⁶⁶ However, after a ruling on a preliminary motion,⁶⁷ the case was settled without the issue being litigated.⁶⁸ *Isaacson* does, however, provide insight into the Service's thinking on the matter, and a ruling on the effect state law will have in determining the outcome. In a preliminary motion to certify two questions of state law to the Colorado State Supreme Court, the P.C. argued that under state law a P.C. could not accumulate earnings for purposes of paying dividends to shareholders.⁶⁹ Further, it argued that a P.C. could only compensate its employees commensurate with the services rendered by each.⁷⁰ The Court of Claims ruled that the law under a state professional corporation act is not controlling for purposes of interpreting section 162.⁷¹ The court conceded, however, that the characterization of payments by a P.C. under state law could be a factor to consider.⁷²

During the subsequent settlement proceedings, the Service expressed the opinion that the intangibles in a professional corporation, such as long-term employment contracts, require a return on investment just "as if the intangibles were invested capital."⁷³ The Service also argued that the value of the P.C.'s tangible assets, such as its library, were assets on which the shareholders should receive a return on investment other than in the form of compensation.⁷⁴

65. 79-2 U.S. Tax Cas. (CCH) 87695 (Ct. Cl. 1979); see generally Rosenbaum, *supra* note 9, for a discussion of this case.

66. See Rosenbaum, *supra* note 9 at 140-41.

67. 79-2 U.S. Tax Cas. (CCH) at 87695; see *infra* notes 69-72 and accompanying text.

68. After receiving an unfavorable opinion on the use of state professional corporation law to determine the deductibility of compensation, the law firm felt "it did not appear economically feasible to obtain a determination." Rosenbaum, *supra* note 9 at 140.

69. 79-2 U.S. Tax Cas. (CCH) at 87695; Rosenbaum, *supra* note 9 at 138-39.

70. See authorities cited *supra* note 69.

71. 79-2 USTC at 87696. The court stated that:

We cannot accept the proposition, however, that characterization of payments as reasonable compensation for purposes of federal income taxation is a question controlled by state law. That position is contrary to the principles of *Burnet v. Harmel*, 287 U.S. 103 (1932), that state law controls only when the operation of the federal taxing act, by express language or necessary implication, makes its operation dependent upon state law. There is no question in this case about the nature of a property right as there was in *Imel v. United States* [75-2 USTC ¶ 9696], 523 F.2d 853 (10th Cir. 1975). Plaintiff has the burden to show that the payments at issue were reasonable compensation under the Internal Revenue Code. How the payments are characterized under state law may be a factor to be considered, but it is not a controlling factor. Cf. *Chism's Estate v. Commissioner* [63-2 USTC ¶ 9640], 322 F.2d 956 (9th Cir. 1963).

72. See *supra* note 71.

73. Rosenbaum, *supra* note 9 at 140. The cited article further states:

The Service apparently believes that if a professional corporation has a long-term employment contract with its lawyer-employees, these contracts constitute intangible assets of the corporation which are capable of valuation and accordingly require a return on their value in the form of a dividend. If the employment contracts have a right of termination based on a short period of time, i.e., either party can terminate, this contract does not then become a valuable asset of the corporation.

Id.

74. *Id.* The Service was apparently "attempting to attribute some sort of appreciated value to the assets in determining whether to accept settlement." *Id.*

Departure from the Automatic Dividend Rule

While the Court of Claims seems to consistently apply the automatic dividend rule, both the Tax Court and the Service appear to have adopted more rational case-by-case approaches to the problem. The Service has ruled that a compensation deduction "will not be denied on the sole ground that the corporation has not paid more than an insubstantial portion of its earnings as dividends on its outstanding stock."⁷⁵ The Tax Court, rather than focusing on the corporation's history of dividend payments, focuses on the "intent" of the corporation in making the compensation payments to the employee-shareholders.⁷⁶ In other words, consistent with the "purely for services" prong of the deductibility test, the Tax Court looks to whether the corporation "intended" the payments to compensate the individuals for services performed in their employee capacities, or whether the payments were really intended as disguised dividends to the individuals in their shareholder capacities. Thus, the presence or absence of dividends becomes only one of many factors to be considered in determining the corporation's intent.

A recent example of the Tax Court's application of the "purely for services" test occurred in *Eduardo Catalano, Inc. v. Commissioner*.⁷⁷ Mr. Catalano, a famous architect, was sole owner and employee of a professional architectural service corporation, Eduardo Catalano, Inc. (ECI).⁷⁸ His primary reasons for incorporating were to limit his personal liability and to take advantage of corporate pension benefits.⁷⁹ Mr. Catalano's annual compensation was generally set early in the year by the board of directors based on the corporation's anticipated income.⁸⁰ For the years 1969 through 1973, he was paid \$112,500, \$112,500, \$112,500, \$150,000, and \$227,400, leaving the corporation with pre-tax net income of \$27,350, \$24,800, \$17,601, \$19,414, and \$525 respectively.⁸¹ At no time did the corporation pay any dividends, however.⁸²

After holding that the compensation paid Mr. Catalano was reasonable in amount, the court turned to the question of whether the payments

75. Rev. Rul. 79-8, 1979-1 C.B. 92. The Service essentially ruled that it will not follow the *McCandless* automatic dividend rule. *Id.* Therefore, the impact of *McCandless* should be lessened in the Court of Claims. See Rosenbaum, *supra* note 9 at 139, stating: "The Court of Claims was selected because . . . the Service had ruled that it would not follow the *McCandless* doctrine."

76. See Comment, *supra* note 21, at 127-29, for a full development of this theory; see also *Drexel Park Pharmacy, Inc. v. Comm'r*, 39 T.C.M. (CCH) 788, 795 (1979) ("Whether the respective petitioners intended the payments to be compensation for services presents a question of fact, to be resolved on the basis of all the surrounding facts and circumstances."); *Laure v. Comm'r*, 70 T.C. 1087, 1098 (1978), *acq.*, 1979-21 I.R.B. 5 (even though a payment would be reasonable if paid as compensation for personal services, it will not be "deductible if it was not intended to be payment for personal services actually rendered.").

77. 38 T.C.M. (CCH) 763 (1979).

78. *Id.* at 763.

79. *Id.* at 764.

80. *Id.* The court explained that since Mr. Catalano generally collected contract fees based on a percentage of completion basis the fees outstanding could easily be determined, making it easy to anticipate ECI's earnings for the forthcoming year. *Id.* at 764-67.

81. *Id.* at 764.

82. *Id.*

were purely for services.⁸³ The court considered various factors including "(1) the corporation's history of dividend payments, (2) the availability of funds for distribution, (3) a comparison of gross and net income of the corporation in relation to the compensatory amount, and (4) the method used to compute compensation."⁸⁴ The court found that the corporation had paid no dividends, and for the two years in question had paid Mr. Catalano 88.5% and 99.8% of pre-salary net earnings respectively.⁸⁵ However, the amounts represented only 22.05% and 31.69% of ECI's gross income.⁸⁶ Another important factor considered was that Mr. Catalano's salary was determined early in the year based on the work already performed with respect to the anticipated earnings of ECI.⁸⁷ The court, therefore, concluded that the payments were properly characterized as compensation, despite ECI's nonpayment of dividends.⁸⁸

Thus, the Tax Court seemed to have repudiated the automatic dividend rule, inserting instead its own intent rule.⁸⁹ In dictum, however, the court did express concern over the absence of dividends, implying that had ECI been more than five years old the outcome might have been different.⁹⁰ The court explained that there would come a time when a non-employee shareholder in such a corporation would demand a return on his investment.⁹¹

While the dictum in *Catalano* suggested that the Tax Court might follow a modified version of the automatic dividend rule (i.e., requiring dividends at some point in time), the court did not seem to take into consideration the special nature of a P.C.⁹² By state statutes most P.C.'s

83. *Id.* at 766. The court explained: "Mr. Catalano is a renowned architect. As the sole employee of ECI he is the fount of that company's income. In light of the fact that ECI had adequate sources from which it could pay Mr. Catalano without threatening its own financial status, it is difficult to support a finding that such payments were unreasonable in amount." *Id.*

84. *Id.* (citing *Klamath Medical Serv. Bureau v. Comm'r*, 261 F.2d 842 (9th Cir. 1958), *cert. denied*, 359 U.S. 966 (1959); *Mayson Mfg. Co. v. Comm'r*, 178 F.2d 115, (6th Cir. 1949); *Miles-Conley Co. v. Comm'r*, 173 F.2d 958 (4th Cir. 1949)).

85. *Id.*

86. *Id.*

87. *Id.*; see *supra* text accompanying note 77.

88. 38 T.C.M. (CCH) at 766-67.

89. See *supra* note 76 and accompanying text.

90. 38 T.C.M. (CCH) at 767. The court stated:

Admittedly we are somewhat disturbed by ECI's historical failure to make a dividend distribution. If its stock were owned by an unrelated third party who had advanced capital, there would naturally come a time when that party would become restless over ECI's failure to make a return on his investment. ECI's first fiscal year ended in 1969. We are not prepared to say that it had reached that point with respect to its taxable years 1972 and 1973. Therefore, based on all the facts and circumstances, we find that ECI properly characterized its payments to Mr. Catalano as compensation.

Id.

91. See *id.*

92. *But cf.* David Kipnis, 44 T.C.M. (CCH) 849, 855 n.9 (1982). There, the Tax Court stated:

Petitioners argue that [the corporation's] existence depended so greatly on [the employee-shareholder] that we should consider it as similar to a professional service corporation, and his salary as similar to the professional's earned income, for which, he argues, there are no limits on "reasonableness." Although we agree that [the employee-shareholder] was the driving force behind [the corporation], we think that his contributions—time, money, management, inventions—do not transform a corporation engaged in manufacturing with total assets listed on the balance sheet for FYE 1978 in excess of

cannot have "unrelated third party" shareholders.⁹³ Therefore, the premise of the dictum—that "unrelated third party" shareholders would demand a return on their capital advances—fails in the case of a P.C. wherein all shareholders act in the dual capacity of employee-shareholders.

Special Considerations for P.C.'s

As the Service hinted during its settlement of the *Isaacson* case, there is a practical reason for requiring dividend payments by a P.C. in certain circumstances.⁹⁴ To the extent that a P.C. has valuable assets other than the services of its employee-shareholders, such assets in theory should yield a return on investment to the corporation and its shareholders.⁹⁵ Therefore, to the extent the corporation's profits are attributable to such assets, they must be distributed to the shareholders in the form of dividends as opposed to compensation. Determining what those assets are, their values, and what rates of return they should yield is another matter which has not been squarely faced by the courts. Even in *McCandless*, where the Court of Claims applied its automatic dividend rule, the court was unable to provide any guidance as to how to determine the proper amount of dividends. The court merely held that the company should pay "a return on equity capital equal to 15 percent of net profits (before salaries and Federal income tax)."⁹⁶ In other words, the court did not attempt to ascertain the value of the company's tangible and intangible assets, merely holding that fifteen percent (an apparently arbitrary figure) of the company's profits would be a sufficient return on "equity capital." Surely, where compensation payments have been found to be reasonable in amount, there should be stronger justification for any resulting reclassification as dividends.

Despite the computational problem encountered when reclassifying reasonable compensation payments as dividends, the Court of Claims, as well as the Tax Court and the Service to some extent, seem to take the approach that the requirement of dividends is just a cost of incorporation which cannot be avoided by a successful corporation.⁹⁷ In favor of this trend, the Service could argue that to the extent a P.C. attempts to pay out all or most of its pre-salary income each year in the form of compensation, thus reducing its taxable income to zero, the corporate entity is not realizing a profit. In other words, to the extent a P.C. intentionally reduces its

\$2,000,000 into a personal service organization. *If the facts were as petitioners argued them to be, the case would be a much different one.*

Id. (emphasis added).

93. See, e.g., ARIZ. REV. STAT. ANN. § 10-902(4) (1977), which states that: "'Professional corporation' means a corporation organized under this chapter solely for the purpose of rendering one category of professional service and which has as its shareholders, directors, officers, agents and employees only individuals who by this state are duly licensed to render that category of professional service" (emphasis added.)

94. See *supra* notes 73-74.

95. *Id.*

96. 422 F.2d at 1340.

97. See *supra* notes 34-36.

taxable income (and thus its "profits") to zero each year, it is not engaged in a trade or business with the objective of generating a profit at the corporate level. Therefore, under the corporate classification tests of *Morrissey v. Commissioner*⁹⁸ and Treasury Regulation section 301.7701-2,⁹⁹ the very existence of the corporate entity for federal income tax purposes could be challenged.¹⁰⁰ However, case law provides that corporations incorporated under state professional corporation acts need not satisfy the criteria of *Morrissey* or the regulations.¹⁰¹ Instead, it is sufficient that the entity qualifies as a P.C. under applicable state law.¹⁰² The Service, however, might use the same "objective to make a profit test" at the state level, since most state acts require P.C.'s to be organized for profit.¹⁰³ Therefore, if lack of a profit motive is sufficient under state law to prevent incorporation by the state, the Service can insist that a P.C. pay some amount of dividends if the corporation is successful, at the risk of losing its corporate status. This logic, however, seems to require too narrow a reading of state incorporation statutes. Since the term "profit" is not clearly defined under either state or federal law for this purpose, the shareholder-employees can argue that they as individuals *are* profiting from the P.C. Nothing in the statutes states that they must attempt to make a profit as shareholders rather than as employees.

On the other hand, state statutes generally do not expressly require the payment of dividends.¹⁰⁴ Since state law is the basis for treating a P.C. as a corporation for purposes of federal income taxation,¹⁰⁵ to require the P.C. to pay dividends seems to be contrary to the state law which gave the P.C. its corporate status in the first place. However, in *Burnet v. Har-*

98. 296 U.S. 344 (1931). The *Morrissey* Court held that an association must have a majority of the following characteristics in order to be treated as a corporation for purposes of federal income tax laws:

(a) associates; (b) an objective to carry on a trade or business and divide the profits; (c) continuity of life of the enterprise, notwithstanding the death, disability, or withdrawal of its members; (d) the opportunity for centralized management by representatives of the owners; (e) the privilege of limited liability for the owners; and (f) free transferability of beneficial interests in the organization.

Id.; B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.02 (4th ed. 1979). Further, the *Morrissey* Court held that the first two characteristics, including the objective to carry on a trade or business and divide the profits, are essential for corporate status. 296 U.S. at 360.

99. Treas. Reg. § 301.7701-2 (1977). The test under this regulation is essentially identical to that developed in *Morrissey*, discussed *supra* note 98.

100. In other words, if a P.C. intentionally avoids achieving a profit at the corporate level, year after year, by adjusting the compensation payments to employee-shareholders, the Service might argue that the requirement under *Morrissey* (see *supra* note 98) that a corporation have an objective to carry on a trade or business and divide the profits, is not satisfied. See *supra* notes 98-99.

101. See *Kurzner v. United States*, 413 F.2d 97 (5th Cir. 1969); *United States v. O'Neill*, 410 F.2d 888 (6th Cir. 1969); *Empey v. United States*, 406 F.2d 157 (10th Cir. 1969); *Holder v. United States*, 289 F. Supp. 160 (1968), *aff'd*, 412 F.2d 1189 (5th Cir. 1969).

102. See cases cited *supra* note 101.

103. See generally ARIZ. REV. STAT. ANN. § 10-908 (1977) which states that a P.C. must be "formed . . . with the object and purpose of engaging in the practice of . . . rendering . . . professional service and dividing the gains therefrom."

104. See generally ARIZ. REV. STAT. ANN. § 10-045 (1977) which provides that the "board of directors of a corporation may, for [sic] time to time, declare and the corporation may pay dividends." (Emphasis added).

105. See cases cited *supra* note 101.

mel,¹⁰⁶ the United States Supreme Court held that state laws are controlling in matters of federal taxation, only where the federal taxing act expressly provides or necessarily implies that state laws control.¹⁰⁷ Nowhere in the language of section 162 is there any express reliance on state law for purposes of distinguishing dividends from compensation, nor is there a necessary implication that state law be relied upon.¹⁰⁸

Even if the state law were applicable, however, there is no reason to believe a different outcome would be reached. Consistent with state law, the I.R.C. does not require that corporations pay dividends. The I.R.C. merely describes how to treat dividends if a corporation does in fact pay them.¹⁰⁹ Yet, the courts have consistently implied that successful corporations must pay dividends.¹¹⁰ Thus, consideration of state law concerning dividend payments adds little to the issue.

In favor of the P.C. being able to avoid payment of dividends, the suggestion has been made that the value of stock ownership in a professional law corporation is not as an investment but rather the opportunity to have a voice in the policies and management of the firm.¹¹¹ Generally, law firms and other professions are incorporated primarily for the purpose of obtaining limited liability and favorable retirement plans available through incorporation.¹¹² In addition, it is argued that a professional should not receive less in compensation than a sole practitioner or partner in a partnership, due merely to the incorporation of the practice.¹¹³

This argument is not without support in the I.R.C. An analogy can be made to the old maximum tax rules of section 1348,¹¹⁴ wherein it was nec-

106. 287 U.S. 103 (1932); see discussion *supra* note 71.

107. 287 U.S. at 110; see discussion *supra* note 71.

108. See I.R.C. § 162 (1982). One author states that "what the distributing corporation may call a dividend, or what the state law may call a dividend, or even what the recipient thinks of without question as a dividend, is not necessarily a 'dividend' for federal income tax purposes." Rudick, "Dividends" and "Earnings on Profits" Under the Income Tax Law: *Corporate Non-Liquidating Distributions*, 89 U. PA. L. REV. 865, 866 (1941) (footnotes omitted). Rudick further states that "the legality of a dividend declaration under state law has no bearing on the question of its status for income tax purposes." *Id.* at 866 n.7.

109. See I.R.C. §§ 301, 316 (1982).

110. See, e.g., *Charles McCandless Tile Serv. v. United States*, 422 F.2d 1336, 1339 (1970) (the "operative facts" revealed that the corporation "had neither declared nor paid dividends to its shareholders in any amount since its formation"); *Eduardo Catalano, Inc.*, 38 T.C.M. (CCH) 763, 767 (1979) (the court was "disturbed" by the corporation's failure to pay dividends).

111. Rosenbaum, *supra* note 9 at 139, 141.

112. B. BITTKER & J. EUSTICE, *supra* note 98, at ¶ 2.06. See *Eduardo Catalano, Inc. v. Comm'r*, 38 T.C.M. 763, 764 (1979) (Mr. Catalano, a professional architect, incorporated primarily to limit his personal liability and receive the pension benefits available to the corporate form.). See also Chapman, *The Future of Personal Service Corporations*, 24 ARIZ. L. REV. 503 (1982), for a discussion of the post-TEFRA advantages and disadvantages remaining for corporate employees.

113. Rosenbaum, *supra* note 9 at 141. Mr. Rosenbaum states:

The logic of this theory is based on the economic facts of practice that professionals are entitled to be paid what other professionals in unincorporated businesses make, such as the sole practitioner or partner. If an attorney who practices individually or is a partner in a law partnership is receiving X dollars per year, and the attorney's counterpart—an employee of a professional corporation—cannot receive a similar amount, the counterpart might decline to participate in a professional corporation.

Id.

114. See *supra* note 17 for a discussion of I.R.C. § 1348.

essary to distinguish between personal service income and income from capital investment. The regulations to this section stated that in the case of a professional such as a lawyer, the business would not "be treated as a trade or business in which capital is a material income-producing factor" despite the presence of substantial investments in capital assets such as equipment and office space.¹¹⁵ The regulation termed such capital assets as "only incidental" to the professional's practice.¹¹⁶ While the maximum tax provision was applicable only to the earnings of individuals as opposed to corporations, the underlying rationale seems contrary to the Service's position in *Isaacson*.¹¹⁷ If the capital assets of a law firm were considered incidental for purposes of favorable tax treatment under section 1348, then there appears to be no logic for treating the assets as material for purposes of section 162(a)(1).

Suggested Application of Section 162(a)(1) to P.C.'s

P.C.'s vary substantially from one to another in aspects such as value of tangible and intangible assets, retained earnings, and numbers of non-shareholder employees. Based on this assumption, a general proposition that P.C.'s be allowed to distribute all their profits in the form of compensation appears inconsistent with the traditional "facts and circumstances" determination.¹¹⁸ The automatic dividend rule requiring dividends of all corporations seems just as inconsistent. A better solution is to evaluate, on a case-by-case basis, the true components of a P.C.'s pre-salary profits. To the extent that fees collected do not represent actual services provided by the employee-shareholders, or represent the value of the corporation's assets (other than services) to its clients, there appears to be no justification for allowing the P.C. to completely avoid payment of dividends to its employee-shareholders. Even though the regulation to section 1348 suggested that the capital assets of a P.C. may be "incidental,"¹¹⁹ the I.R.C. itself disallows as earned income "that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered."¹²⁰

115. Treas. Reg. § 1.1348-3(a)(3)(ii) (1976).

116. *Id.*

117. See *supra* notes 73-74 and accompanying text for discussion of the Service's position in *Isaacson*.

118. See Worthy, *IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations*, 32 J. TAX'N. 88 (1970). Mr. Worthy, then Chief Counsel of the I.R.S. and Associate General Counsel of the Treasury, stated:

It might be said that any amounts paid by a professional corporation to its employees are necessarily reasonable compensation, since they represent amounts paid by clients for the employee's services, less overhead and operating expenses of the firm. It might be determined, however, that a portion of the corporation's income is due to goodwill. To the extent that this is so, it cannot be said that the salaries of the professional employees of the corporation are reasonable *per se* merely because they are based on the corporation's billings.

Id. at 91.

119. Treas. Reg. § 1.1348-3(a)(3)(ii) (1976). See *supra* text accompanying note 116.

120. I.R.C. § 911(b) (1981) (referenced by I.R.C. § 1348(b)(1)) (repealed by Pub. L. No. 97-34, § 111(a), 95 Stat. 172 (West Supp. 1982)).

Thus, section 1348 contained essentially the same limiting language as found at regulation section 1.162-7(a).¹²¹

While determination of this amount may be difficult, it is a matter which can be ascertained by a trier of fact, in cases where the Service and the P.C. cannot agree. Since most law firms retain a relatively small amount of capital compared to annual earnings, the actual dividends should be nominal except in windfall years¹²² or where there are a substantial number of non-shareholder employees.¹²³

Conclusion

The two-pronged test of Treasury Regulation 1.162-7 has been consistently used by the Internal Revenue Service as a means of reclassifying alleged compensation payments to employee-shareholders as dividends for purposes of federal income taxes. To the extent this is accomplished, "double taxation" results to the corporate employer since dividends are not deductible by the corporation as are compensation payments. The exact application of the two-pronged test to professional service corporations, however, is uncertain due to the unique nature of a P.C.'s income. This problem recently came to light where a professional law corporation paid out almost all of its current earnings to the attorney-shareholders in the form of compensation to the exclusion of any dividends.

Disregarding the special situation of the professional service corporation, the various courts have been unable to agree on the proper tests to apply to determine the reasonableness of compensation under section 162 of the Internal Revenue Code. The *McCandless* "automatic dividend" rule of the Court of Claims emphasizes the absence of dividends as being the key factor in the determination. The Tax Court, on the other hand, focuses on the intent of the corporation in making the distributions to a shareholder-employee, with the absence of dividends being only one of many factors to be considered.

The nature of the income of a professional service corporation presents an added problem. While the Court of Claims has specifically avoided ruling on whether the *McCandless* doctrine will apply to a P.C., the Tax Court seems to have held in *Catalano* that such a corporation will be expected to pay dividends after its formative years. The arguments for and against requiring the payment of dividends by a professional service corporation suggest that the courts will have to continue applying a facts and circumstances test to each such professional corporation as opposed to

121. See discussion of two-pronged test of Treas. Reg. § 1.162-7(a) *supra* text accompanying notes 15, 24-32.

122. See Rosenbaum, *supra* note 9, at 139, where Mr. Rosenbaum suggests: "Dividend distribution is not normal in a law firm because compensation (the cost of goods sold factor) rises with production. Only in an atypical windfall year would there be dividend opportunity."

123. See Worthy, *supra* note 118, at 91 (Mr. Worthy suggested that "a Corporation whose business consists primarily of rendering professional services may be able to pay out most or all of its income as deductible salary expenses and other expenses."). See also *Petro-Chem. Mktg. Co. v. United States*, 602 F.2d 959, 967 (Ct. Cl. 1979) (Court of Claims distinguished the case from that of a professional corporation on the basis that "the plaintiff's income . . . was not earned solely by the personal services performed by" the employee-shareholders).

adopting a blanket rule either for or against the requirement of dividend payments. On one hand, some of the earnings of most professional service corporations can probably be attributed to circumstances other than the personal efforts of the shareholder-employees. Such circumstances include the existence of non-shareholder employees, and valuable assets such as long-term employment contracts, legal libraries, and good will. Without such assets, a professional corporation's fees would not be as high. This implies that the fees are not attributable solely to the services of the employee-shareholders. On the other hand, the existence and extent of such assets in any one professional corporation and their effect on the earnings of the corporation remains a question of fact to be determined based on the circumstances of each case. If the courts follow this reasoning there will be no special rules or exceptions afforded professional corporations.

