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Topic: Determination of “Reasonable” Compensation for Deduction Purposes Includes Pension Plan Contributions.

MARKET TREND: With an increased focus on compensation planning in light of recent income tax increases, compensation packages are likely to include a variety of features, including pension plan contributions or bonus plans (such as 162 bonus plans used to allow executives to buy life insurance), all of which will be considered in determining the reasonableness of the compensation for business deduction purposes.

SYNOPSIS: The owner-employees of a corporation received large payments of compensation, including pension plan contributions, for the 2003, 2004 and 2005 calendar years. These large payments of compensation were intended as catch-up compensation for inadequate compensation paid to the owner-employees in prior years. The Tax Court applied a six-factor test (provided below) to determine that a portion of the compensation payments was not reasonable and therefore, not deductible by the corporation. In addition, the nondeductible contributions to the pension plan were subject to a 10% excise tax.

TAKE AWAYS: Independent insurance agents dealing with 162 bonus arrangements and various forms of deferred compensation plans should be aware of the issues surrounding unreasonable compensation. In addition, those agents working with pension plans need to remember that pension plan contributions must be deductible or else the employer will be exposed to a 10% excise tax. Although an employer may avoid additional taxes and penalties if the employer relies on the advice of an accountant or attorney that an amount of compensation is deductible, so as to establish that the failure was due to reasonable cause and not due to willful neglect, the 10% excise tax applicable to nondeductible pension plan contributions may not be similarly avoided.

MAJOR REFERENCES: Thousand Oaks Residential Care Home v. Commissioner, TC Memo 2013-10; IRC §162.

OVERVIEW

The recent case of Thousand Oaks Residential Care Home v. Commissioner illustrates the potential liability of an employer in making nondeductible contributions to a pension plan, even if the employer relies on the advice of an accountant or attorney that such amounts are in fact deductible. Thus, pension consultants should take a cautious approach in designing and implementing pension plans for owners of closely held businesses.

CASE BACKGROUND

In 1973, a married couple (the “Owner-Employees”) purchased a concentration of Life Insurance...
corporation (the “Corporation”) that owned and operated an assisted living facility. From 1973 through 1983, the Owner-Employees did not receive any compensation from the Corporation for their services operating the assisted living facility. The amounts received by the Owner-Employees from 1984 to 2001 ranged from zero to $36,000, and each Owner-Employee was paid approximately $130,000 in 2002.

In October of 2002, the Corporation sold the assisted living facility. Effective January 1, 2003, the Corporation created a defined benefit plan (the “Pension Plan”) in which the Owner-Employees were participants. The Corporation paid the husband Owner-Employee wages of $200,000, $200,000, and $30,000 in 2003, 2004, and 2005, respectively, and it contributed $191,433 and $259,506 to the Pension Plan for his benefit in 2003 and 2004, respectively, for a total compensation package of $880,938. The Corporation paid the wife Owner-Employee wages of $200,000, $200,000, and $30,000 in 2003, 2004, and 2005, respectively, and it contributed $191,433 and $198,915 to the Pension Plan for her benefit in 2003 and 2004, respectively, for a total compensation package of $820,348. The accountant for the Owner-Employees advised that the aforementioned compensation payments and contributions to the Pension Plan were reasonable and therefore, deductible under Section 162 of the Code.

The IRS contended that the compensation paid to the Owner-Employees for 2003, 2004 and 2005 was not reasonable under Section 162 of the Code and sought to disallow the deductions by the Corporation for all of the compensation paid to the Owner-Employees for those years, resulting in (i) excise taxes under Section 4972 of the Code for nondeductible contributions to the Pension Plan in 2003 and 2004, (ii) penalties for the failure to file additions to tax, and (iii) accuracy related penalties.

**REASONABLE COMPENSATION ANALYSIS**

The Tax Court held that a portion of the compensation paid to the Owner-Employees for 2003, 2004 and 2005 was not reasonable under Section 162 of the Code, and therefore non-deductible. Section 162(a)(1) of the Code provides a deduction for ordinary and necessary business expenses, including “a reasonable allowance for salaries or other compensation for personal services actually rendered.” Thus, in order for compensation to be deductible under Section 162 of the Code, (1) the payment must be purely for services rendered, and (2) the amount of compensation must be reasonable.

The Tax Court held that the first prong of the analysis was satisfied because the compensation paid to the Owner-Employees for 2003, 2004 and 2005 was intended as compensation for each of the three years at issue, respectively, and as catch-up compensation for prior services actually rendered.

In holding that the “reasonableness” prong of the analysis was not satisfied, the Tax Court applied a six-factor test to the facts. The relevant factors were:

1. The employee’s role in the company (position held and its importance, hours worked, duties, etc.);
2. A comparison of the employee’s salary with salaries paid by similar companies for similar services;
3. The character and condition of the company (size, complexity, net income, general economic condition, etc.);
4. Potential conflicts of interest, primarily in the relationship between the employee and the company;
5. Internal consistency in company’s treatment of payments to its employees; and
6. Whether an independent investor would be willing to compensate the employee as he was so compensated (this sixth factor is only applicable to the Ninth Circuit).
RAMIFICATION OF THE DEDUCTION DISALLOWANCE

IRC §4972 Excise Tax. IRC §4972 imposes a 10% tax on any nondeductible contributions to qualified employer plans. Because the Tax Court held that a portion of the Corporation’s contributions to the Pension Plan was unreasonable compensation and therefore, not deductible under IRC §162, a 10% excise tax was applied to the non-deductible portion of the Corporation’s Pension Plan contributions.

IRC §6651 Additions to Tax. In the case of a failure to file a return on time, IRC §6651(a)(2) imposes an additional tax of 5% of the tax required to be shown on the return for each month or fraction thereof for which there is a failure to file, subject to a 25% cap. In the case of a failure to pay an amount shown as tax on a return on or before the date prescribed for payment of such tax, IRC §6651(a)(2) imposes a similar addition to tax. Neither of these additions to tax will apply if it is shown that such failure is due to reasonable cause and not due to willful neglect. “Reasonable cause” is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney that it was unnecessary to file a return, even when such advice turned out to have been mistaken. The Tax Court held that the Owner-Employees reasonably relied on the advice of their accountant and thus, the Corporation was not liable for the additions to tax under IRC §6651.

IRC §6662 Accuracy Related Penalty. IRC §6662 imposes an accuracy-related penalty on the understatement of tax required to be shown on a return. Again however, there is an exception to the penalty under IRC §6662 when a taxpayer relies on the advice of a tax professional. In this case, however, the exception is conditioned on (1) the adviser being a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer providing necessary and accurate information to the adviser, and (3) the taxpayer actually relying in good faith on the adviser’s judgment. The Tax Court held that the Owner-Employees actually relied on the advice of their accountant who was a competent professional, and that they provided him with the necessary and accurate information, and therefore, the Corporation was not liable for the accuracy-related penalty under IRC §6662 related to the non-deductible Pension Plan contributions.

SUMMARY AND NEXT STEPS

As illustrated in the Thousand Oaks case, employers may be liable for a 10% excise tax on non-deductible contributions made to a qualified retirement plan, which may not be avoided even if the employer reasonably relies on a tax-professional’s advice that the contributions were deductible. Accordingly, independent insurance agents should advise their clients to take the appropriate steps to minimize this risk. Further, as compensation planning proliferates due to tax increases under the American Taxpayer Relief Act and the Patient Protection and Affordable Care Act, insurance programs used as part of compensation planning should be carefully examined with accountants and attorneys to ensure compliance with the reasonableness requirement.

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