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DIGGING THE GOLD OUT OF FAMILY FARM CORPORATIONS

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I. WHOPPING FARM INCOME

Rarely have farmers seen the sort of income they have experienced in the past two years. On Tuesday, November 25, 2008, the United States Department of Agriculture announced that net farm income for 2008 will be $86.9 billion, up from $58.5 billion in 2006—a 49 percent increase in two years. In a local context, a 1,500 acre farm generating $333 net income per acre before land charges will net $500,000 in income. In Iowa, 75 percent of all farmland is owned without debt.[1]

During the 1970s, many farm operations were incorporated for succession planning purposes. Today, the Iowa Secretary of State reports that 8,113 corporations indicated that they own Iowa farmland.[2] The Secretary of State does not have sufficient information to know how many of the 8,113 corporations are taxed as a C corporation or S corporation for Federal income tax purposes.

II. BENEFITS OF TAXATION AS A C CORPORATION

A. Room and Board

A farm corporation taxed as a C corporation can provide tax-free meals and lodging to its employees and the employees' spouses and dependents if the meals are served on the farm and such meals are provided for a substantial noncompensatory business reason of the employer.[3]

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[1] FARMLAND OWNERSHIP AND TENURE IN IOWA 2007, Mike Duffy, ISU Extension, November, 2008.
[2] Harry Davis, Iowa SOS, August 11, 2008. The Secretary of State reports that over 200,000 corporations are registered in Iowa, indicating that just a little over 4 percent of corporations report owning farmland. Other entities reporting owning farmland in Iowa include: limited liability companies (1,817), limited partnerships (275) and Iowa non profit corporations (2).
[3] IRC § 119; Treas. Reg. § 1.119-1(a).

Requiring an employee to live on the farm to monitor crops and work longer hours has been considered a substantial noncompensatory business reason.[4]

The term "meals" includes groceries and non-foodstuffs such as napkins, toilet tissue, and soap.[5] In addition, the cost of the meals is fully deductible by the farm corporation and not subject to the 50 percent limitation of IRC Section 274(n).[6]

Meals provided to S corporation shareholder/employees owning more than 2 percent must be included in their taxable income as additional compensation. Such shareholders cannot exclude the value of meals furnished to them.[7]

B. Lodging

Lodging is excluded[8] from an employee's gross income if furnished: (1) for the convenience of the employer, (2) on the business premises of the employer, and (3) as a condition of employment.[9] The failure to meet any of the above three tests will cause the value of the lodging to be includible in the employee's gross income,[10] although the Tax Court has held that lodging that passes the condition of employment test will also satisfy the convenience of the employer test.[11]

Treasury Regulations which govern the application of the convenience of employer test to meals, also apply to lodging.[12] Thus, lodging furnished for a substantial non-compensatory business reason of the employer is considered to be furnished for the convenience of the employer, even if the lodging is also provided for a compensatory reason.[13] Living on the farm

[4] *J. Grant Farms, Inc. v. Commissioner*, T.C.M. 1985-174 (grain and livestock farm); *Johnson v. Commissioner*, T.C.M. 1985-175 (grain farm). Meals are provided for a substantial non-compensatory purpose if they are furnished to an employee during working hours because the employer's business is such that the employee must be restricted to a short meal period, such as 30 or 45 minutes, and because the employee could not be expected to eat elsewhere in such a short period of time. Treas. Reg. § 1.119-1(a)(2)(ii)(b); Harris Trust & Savings Bank v. United States, 81-1 U.S.T.C. para. 9177 (Ct. Cl. 1981).
[5] *Jacob v. United States*, 493 F.2d 1294 (3rd Cir.1974).
[6] *Boyd Gaming Corporation v. Commissioner*., 117 F.2d 1096 (9th Cir. 1999).
[7] *Dilts v. United States*, 94-1 U.S.T.C. ¶ 50,162 (D.C. Wyo. 1994); IRC § 1372.
[8] The dwelling should also be depreciable by the corporation as 27.5 year residential rental property despite the fact that the dwelling will not generate any cash rental income as required by IRC §168(e)(2). A court would likely consider the employee-tenant's contractual obligation to provide valuable services to the corporation and hold that such services constitute, in part, the payment of rent to the corporation. The dwelling would not be a "farm building" depreciable over 20 years. *Steen v. Commissioner*, 508 F.2d 268 (5th Cir. 1975).
[9] IRC § 119(a).
[10] See *Olkjer v. Commissioner*, 32 T.C. 464 (1959), acq. 1960-1 C.B. 5.
[11] *Vanicek v. Commissioner*, 85 T.C. 731, 739 (1985), acq. 1986-2 C.B. 1; *Bob Jones Univ. v. United States*, 670 F.2d 167, 176 (Ct. Cl. 1982); *United States Junior Chamber of Commerce v. United States*, 334 F.2d 660, 663 (Ct. Cl. 1964).
[12] Treas. Reg. § 1.119-1(a)(2)(i); Rev. Rul. 68-354.
[13] Reg. Section 1.119-1(b); *Johnson v. Commissioner*, T.C. Memo. 1985-175; Rev. Rul. 77-80, modified by Rev. Rul. 81-222.

to monitor crops and work longer hours has been considered a substantial noncompensatory business reason.[14]

The term "lodging" encompasses items such as heat, electricity, gas, water, and sewage services.[15] If an employer furnishes utilities that are necessary to make the lodging habitable, the value of the utilities is excluded from income if the value of the lodging is also excluded.

C. Health and Medical Benefits

A corporation can provide unlimited health and medical benefits to its employees [check on this—the 2010 Health Care Acts may have put a limit on this]. In *Schellito v. Commissioner*, 108 AFTR 2d 2011-5952 (8/24/2011), a farmer hired his wife as an employee and paid her in the form of health insurance. The Tax Court sided with the IRS, but the Tenth Circuit overruled and held the insurance deductible by the husband-farmer and excluded from the wife's income. Health insurance and medical expenses reimbursements are deductible by the employer and excludible by the employee even if the only form of compensation paid to the employee is health insurance. *Speitz v. Commissioner*, T.C. Summ. Op. 2006-25, 2006 WL 334296 (Feb. 14, 2006).

D. Low Tax Rate on First $50,000

Corporations pay tax on income at progressive marginal rates. The first $50,000 of taxable income is taxed at 15 percent.[16] Until January 1, 2011, dividends paid by a corporation to its shareholders are generally taxed to the shareholder at a maximum 15 percent rate.[17] The combined 15 percent rate of the corporation and the 15 percent rate of the dividend equal 30 percent which is less than the current highest marginal rate of 35 percent for individuals. Thus, if a farm corporation's income is sufficiently managed to average approximately $50,000 of taxable income a year, tax savings can occur.

III. BURDENS OF TAXATION AS A C CORPORATION

A. Quickly Progressing Rates

[14] *J. Grant Farms, Inc. v. Commissioner*, T.C.M. 1985-174 (grain and livestock farm); *Johnson v. Commissioner*, T.C.M. 1985-175 (grain farm). Meals are provided for a substantial non-compensatory purpose if they are furnished to an employee during working hours because the employer's business is such that the employee must be restricted to a short meal period, such as 30 or 45 minutes, and because the employee could not be expected to eat elsewhere in such a short period of time. Treas. Reg. § 1.119-1(a)(2)(ii)(b); Harris Trust & Savings Bank v. United States, 81-1 U.S.T.C. para. 9177 (Ct. Cl. 1981).

[15] *Benninghoff v. Commissioner*, 71 T.C. 216 (1978), aff'd, 614 F.2d 398 (5th Cir. 1980); *Turner v. Commissioner*, 68 T.C. 48 (1977); Rev. Rul. 68-579.

[16] IRC § 11(b).

[17] IRC § 1(h)(11).

The corporation's tax rate increases from 15 percent at its first $50,000 of taxable income to 39 percent at taxable income exceeding $100,000.[18] A corporation with farm profits of $300,000 will pay marginal income tax rates that are higher than those for individuals.

B. Double Taxation

Shareholders of corporations are taxed twice in two separate circumstances. First, earnings of the corporation are taxed at corporate rates that quickly escalate after the first $50,000 of taxable income. Those earnings are then taxed again when distributed as dividends to the shareholder.

Second, two separate and distinct assets are created upon the formation of a corporation--the operating assets of the corporation and the stock representing them. Both increase in value as the corporation becomes more profitable and both are subject to separate taxation based on the amount of gain reflected in each form of asset. Thus, a corporation is subject to double taxation when the assets of the corporation are sold and the stock representing those assets is sold.

For example, an individual contributes $50,000 to begin operations of a new farming business that will be operated as a corporation. The individual receives stock from the corporation with a tax basis of $50,000 and the corporation immediately invests the cash in an operating facility. The operating facility will also have a tax basis of $50,000 to the corporation. After a year, the corporation liquidates. Assuming there were no profits from business for the year, but that real estate prices doubled making the facility worth $100,000, the corporation recognizes capital gain income of $50,000 and pays tax at the corporate rate of 15% or $7,500 (there is no preferential capital gain rate for corporations).

In addition, the value of the individual's stock increased in value to $92,500 as a reflection of the more valuable operating facility (less the amount of corporate taxes). Thus, the individual will also recognize gain on the redemption of his stock in the amount of $42,500. Assuming the gain was long term capital gain taxed at the 15% rate, the individual's tax bill will be $6,375 due to the liquidation. The transaction can be summarized as follows:

	Individual	Corporation
Investment:		
Stock	$50,000.00	
Operating Facility		$50,000.00
Value at Liquidation:		
Stock	$92,500.00	
Operating Facility		$100,000.00
Gain	$42,500.00	$50,000.00
Tax Rate	15.00%	15.00%
Tax	$6,375.00	$7,500.00

[18] IRC § 11(b). Taxable income exceeding $100,000 and less than $335,000 is taxed at 39 percent. Taxable income exceeding $335,000 up to $10,000,000 is taxed at 34 percent.

Total Tax	$13,875.00

If the same individual had chosen the sole proprietorship or a flow through form of organization, the operating facility would have been liquidated as an asset of the individual with the gain taxed as a capital gain to the individual. Given the same course of events, the individual's tax bill would only be $7,500 (($100,000 - $50,000) * .15), allowing a savings of $6,375 ($13,875 - $7,500).

IV. WHAT TO DO

A. Elect S Corporation Status

If a farm corporation that generally generates about $50,000 of taxable income a year suddenly finds itself with $500,000 of taxable income, it should consider filing Form 2553 to become an S corporation. An S corporation is a pass-through entity and its taxable income is reported by its shareholders. Consequently, S corporations avoid double taxation of income.

1. Election Procedure. A completed Form 2553 with signatures of all shareholders must be filed with the IRS.

2. Timing of Election. An election must be filed before the 15th day of the third month of the corporation's tax year.[19] Thus, for a calendar year corporation, the election must be filed by March 15th. Note the distinction between the "*15th day of the third month*" and "*three and one-half months*."

Generally, S corporations must adopt a calendar tax year.[20] A fiscal year end C corporation can elect S status effective after the end of the C corporation's fiscal year, or as of the beginning of the new calendar year. In either situation, a short period return will need to be filed.[21]

> **EXAMPLE**: C corp with a June 30, 2008, year end elects to be taxed as an S corporation effective on July 1, 2008. The corporation will file a short period S corporation return for the period July 1, 2008, to December 31, 2008. Alternatively, C corp could elect to be taxed as an S corporation effective January 1, 2009. C corp would be required to file a short period return as a C corporation for the short period from July 1, 2008, to December 31, 2008.

[19] IRC § 1362(b)(1).
[20] IRC § 1378. An S corporation can adopt a fiscal year if it can establish a business purpose for the fiscal year.
[21] Rev. Proc. 2006-45.

3. Pitfalls.

(i) Permitted Shareholders. Only individuals, estates, certain trusts, banks and certain exempt organizations can be shareholders of an S corporation. Partnerships and corporations cannot be shareholders. An estate cannot hold S corporation stock longer than the period necessary to wrap up administration of the estate.[22]

A trust is eligible only if its beneficiaries are individuals, estates or charitable organizations.[23] A trust, other than a grantor trust or a voting trust, must make a special election in order to be a permitted shareholder. A Qualified Subchapter S Trust ("QSST") is a trust that has just one income beneficiary and a requirement that all the trust income must be distributed to the beneficiary.[24] An Electing Small Business Trust ("ESBT") is a trust with multiple income beneficiaries.[25] An ESBT election comes with a cost: the income of the S corporation allocated to it is taxed at the highest individual income tax rate (currently, 35 percent).[26] Both trusts must file an election with the IRS within 2 ½ months after the trust acquires shares of the S corporation stock.[27] The form for filing a QSST election is on Form 2553. No particular form is prescribed for an ESBT election. A sample ESBT election is attached hereto.

(ii) Passive Income Termination. If an S corporation has accumulated earnings and profits (i.e., old C corp retained earnings) at the close of its taxable year, and more than 25 percent of its gross receipts is passive investment income, a tax is imposed on the income of the corporation for the taxable year.[28] The tax is computed by multiplying the excess net passive income by the highest corporate tax rate.[29] No credit is allowed against this tax, except for the fuel tax credits allowed under Code Section 34.[30] If an S corporation with accumulated earnings and profits has more than 25 percent of its gross receipts in passive investment income for three consecutive years, the corporation's S status is terminated.[31]

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[22] *Old Virginia Brick Co. v. Commissioner*, 367 F.2d 276 (4th Cir. 1966).
[23] IRC § 1361(e)(1)(B).
[24] IRC § 1361(d)(3).
[25] IRC § 1361(e).
[26] IRC § 641(c).
[27] IRC § 1361(d)(2)(D); Treas. Reg. § 1.1361-1(m)(3)(iii).
28 IRC § 1375. Under prior law, an S election automatically terminated in any year in which the S corporation had more than 20 percent of its gross receipts in the form of passive income. Congress was anxious to have S corporation privileges granted only to active businesses, but wanted to avoid the use of S corporations to hold portfolio or other investments. Even though Congress eventually became willing to allow S corporations to be used as investment vehicles in general, there remained concern that shareholders of C corporations holding passive investments would have access to retained corporate earnings without liquidating the corporation and paying an additional tax. Focus then turned to S corporations that had previously been C corporations and, therefore, inherited C earnings and profits. As a result, Congress chose to enact the special corporate tax on excessive passive investment income found in Code Section 1375, and a new termination rule (Code Section 1362(d)(3)). The revised rules are more sensible and favorable than the old termination rules. Now, an S corporation will not so often be trapped if it happens to have a year of high passive income because it is in a cash heavy start-up mode or interim period between sale of a major operating asset and reinvestment.
[29] IRC § 1375(a).
[30] IRC § 1375(c).
[31] IRC §1362(d)(3).

Although the Code does not define gross receipts, the regulations provide that the term generally means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income and is not reduced by returns and allowances, cost of goods sold, or deductions.[32] Gross receipts do not include amounts received under Code Section 331 (relating to certain liquidations); amounts received in non-taxable sales or exchanges (except to the extent that gain is recognized by the corporation on the sale or exchange); or amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.[33]

When the passive investment income tax is imposed on an S corporation, each item of passive investment income passed through to the shareholders is reduced by an amount that bears the same ratio to the amount of the passive investment income tax as the amount the item bears to the total passive investment income for the taxable year.[34] Therefore, an S corporation with Subchapter C earnings and profits will not be a good candidate to serve as a holding company for a person's investment assets, but a new S corporation (without C earnings and profits) can serve very well as such, avoid a corporate-level income tax, and avoid a Code Section 541(personal holding company) tax.

The best way to avoid the passive investment income tax is to have the corporation distribute all accumulated earnings and profits as a taxable dividend to shareholders. If the end of the taxable year is approaching and it looks like the S corporation is going to have a problem with the passive investment income tax, the earnings and profits may be distributed before the end of the year, and the passive tax will be avoided.

> PRACTICE TIP: Practitioners may want to compare the client's tax rate for the current year with what it is projected to be for the following two years. If the client will be in a lower tax bracket in the following years, it may be better to postpone the distribution of earnings and profits. Practitioners must also take into account the projected passive investment income tax, which will be paid by the S corporation but will reduce the amount, which can be distributed to shareholders.
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> OBSERVATION: An S corporation with accumulated earnings and profits is not a good candidate to serve as a holding company for an individual's investment assets, but an S corporation without C earnings and profits could hold such assets. The analogy is simple - the tax burden falls on the individual

[32] Treas Reg. § 1.1362-2(c)(4)(i).
[33] Treas. Reg. § 1.1362-2(c)(4)(ii)(B)(2) and Treas. Reg. § 1.1362-2(c)(4)(iii). See, e.g., *Helis v. Usry*, 464 F.2d 330 (1972)(because transactions were non-taxable exchanges under Code Section 1031, amounts received did not constitute gross receipts).
[34] IRC § 1366(f)(3).

> shareholder and tax is imposed currently at the shareholder's rate just as if the shareholder had held the investments directly. In addition, by using an S corporation, as opposed to a C corporation, the Code Section 541 personal holding company tax is avoided.

Because the passive income tax rules look to accumulated earnings and profits at the end of the year, there was some question as to what happened when a corporation with passive investment income and accumulated earnings and profits liquidated in the middle of the year. Did the liquidating distribution remove accumulated earnings and profits before such earnings and profits are considered for the passive income tax or are those earnings first considered for the passive income tax rules? The IRS has held that the corporation, by distributing all its property to shareholders in liquidation, eliminates any problem with the passive income tax.[35] The S corporation's final taxable year closes after the liquidating distribution and the amount of S corporation's accumulated earnings and profits is measured following the liquidating distribution. In other words, the amount of accumulated earnings and profits remaining at the close of the taxable year will have been reduced by taking into account the liquidating distribution under Code Section 312.

(iii) Built In Capital Gains Tax. Code Section 1374 imposes a corporate-level tax on gain from certain property sales made in the ten-year period following an S election by a C corporation. The tax is commonly referred to as the built-in gains tax, or BIG tax. After the ten year period, the sale of assets that appreciated during C corporation years will only result in one level of tax.

> PRACTICE TIP: Because of its considerable "sting" and because it cannot be easily avoided, the Code Section 1374 tax must carefully be considered before a C corporation makes an S election. If such an election is to be made, contemporaneous appraisals are imperative in order to pin down the amount of gain built in at the time of conversion to S status. (Post-election appreciation is not subject to BIG tax, but the burden is on the taxpayer to show the amount of built-in gain and hence the amount of gain that accrued after election and is that is beyond the reach of the Code Section 1374 BIG tax.)

(iv) Meals and Lodging Not Available for S Corporation Shareholders. Shareholder/employees cannot exclude the value of meals and lodging provided to them by the corporation. Consequently, the fair value of the meals and lodging must be included as part of their taxable compensation.[36]

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[35] PLR 9747035.
[36] *Dilts v. United States*, 94-1 U.S.T.C. ¶ 50,162 (D.C. Wyo. 1994); IRC § 1372.

B. Reasonable Compensation

If a shareholder has the ability and the desire to work for his or her corporation, and has the luxury of controlling its board of directors and its management, then such a shareholder may not have a need to receive dividends from his or her stock. The IRS, however, places constraints on the shareholders unfettered authority to pay all the earnings and profits to him or herself in the form of compensation.

1. Reasonable vs. Unreasonable Compensation

Taxpayers may deduct as ordinary and necessary expenses paid or incurred in carrying on a trade or business, a reasonable allowance for salaries or other compensation for personal services actually rendered.[37] The test of deductibility for compensation payments is a two-part test: (1), whether the payments are reasonable, and (2), whether the payments are purely for services.[38] This outline will discuss the first of the two.[39]

In general, reasonable compensation is the amount that would ordinarily be paid for like services by like enterprises under like circumstances. Treas. Reg. § 1.162-7(b)(3). The reasonableness of compensation is a question of fact to be determined on the basis of all the facts and circumstances.[40] Traditionally, the determination of whether compensation is reasonable is made by examining a number of factors, with no single factor being decisive, sometimes referred to as the multi-factor approach.[41] Courts have amassed lists including as many as 21 factors in evaluating reasonableness of compensation.[42] The principal factors are as follows:

(i) The employee's responsibilities and duties in the organization; the type and extent of the services rendered; the employee's qualifications, hours worked, duties performed, and his importance to the company's success.[43]

(ii) The prevailing compensation paid to employee's with that paid by similar companies in similar industries for similar services.[44]

(iii) The scarcity of qualified employees; the employee's prior earning capacity; and his or her contributions to the business venture.

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[37] IRC § 162(a)(1).
[38] Treas. Reg. § 1.162-7(a).
[39] See *Pediatric Surgical Associates v. Comr.* T.C. Memo 2001-81 (April 2, 2001) (compensation of shareholders of professional corporation was partly derived from services performed by nonshareholder associates and thus a dividend).
[40] *Pacific Grains, Inc. v. Commissioner*, 399 F.2d 603 (9th Cir. 1968), aff'g T.C. Memo. 1967-7.
[41] *Mayson Manufacturing Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949).
[42] See, e.g., *Foos v. Commissioner*, 41 T.C.M. 863, 878-79 (1981).
[43] *American Foundry v. Commissioner*, 536 F.2d 289 (9th. Cir. 1976), aff'g in part and rev'g in part 59 T.C. 231 (1972); *Damron Auto Parts, Inc. v. Commissioner*, T.C. Memo. 2001-197.
[44] *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

(iv) The company's size as indicated by its sales or capital value; the complexities of the business; the general economic conditions; and the peculiar characteristics of the business.

(v) Whether the relationship between the company and the employee whose compensation is at issue might permit the company to disguise non-deductible corporate distributions of income as deductible compensation. A potential for such abuse exists when the employee whose compensation is at issue is the company's sole or controlling shareholder.[45]

(vi) Whether the compensation is paid pursuant to a structured, formal, and consistently applied program. Bonuses not paid pursuant to such plans are suspect.[46]

However, in recent years, several appellate circuit courts have been focusing on a simpler and more unified view of the various factors. This examination is known as the independent investor test.[47]

Under this test, the reasonableness of compensation is assessed in terms of whether an inactive, independent investor would be willing to compensate the employee as he was compensated.[48] This is not a separate autonomous factor under the multi-factor test; rather it provides a focal point for the entire analysis.[49] Under this analysis, the question becomes: Given the dividends and return on equity by a disinterested shareholder, would that shareholder approve the compensation paid to the employee?

For example, in applying this test in *Exacto Spring Corporation v. Commissioner*,[50] the Seventh Circuit noted that the IRS's expert testified that investors in a firm like *Exacto* would expect a 13 percent return on their investment. In fact, investors were receiving a 20 percent return. Accordingly, the Seventh Circuit held that the employee's compensation (the employee being its co-founder, chief executive, and principal owner) was reasonable because the investors were obtaining a far higher return than they had any reason to expect.

The court also noted the failure of the Tax Court's reasoning to support its result in using the multi-factor test. The court found that the multi-factor test, as used by the IRS and upheld by the Tax Court, did not provide adequate guidance to a rational decision. The court observed the judges are not competent to decide what business executives are worth.

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45 *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983); see Treas. Reg. § 1.162-7(b)(3).
46 *Charles Schneider & Co. v. Commissioner*, 500 F.2d 148 (8th Cir. 1974), aff'g T.C. Memo. 1973-130, cert. denied, 420 U.S. 908 (1975); Treas. Reg. § 1.162-7(b)(1).
47 *Menard, Inc. v. Commissioner*, 103 AFTR 2d ¶2009-609 (7th Cir. 2009); *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983); *Nor-Cal Adjusters v. Commissioner*, 503 F.2d 359 (9th Cir. 1974), aff'g T.C. Memo. 1971-200; *Harrison v. Commissioner*, T.C. Memo 2003-239.
48 *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983).
49 *Dexsil v. Commissioner*, 147 F.3d 96 (2d Cir. 1998).
50 196 F.3d 833 (7th Cir. 1999).

In contrast, in *Eberl's Claim Service, Inc. v. Commissioner*,[51] the Tenth Circuit declined a taxpayer's invitation to apply the independent investor test and instead applied the multi-factor test. The court determined that, absent an en banc rehearing, it was bound to use the multi-factor approach by its prior decision in *Pepsi-Cola Bottling v. Commissioner*.[52]

The First Circuit also has indicated that it prefers the multi-factor test over the independent investor test, stating that multiple factors often are relevant in reasonable compensation cases.[53]

In determining whether compensation is reasonable, courts may consider amounts paid in the current year for services rendered in previous years where such services were inadequately compensated for in those years.[54] The size of the salary or the fact that it may represent an inordinately large increase over prior years is not necessarily determinative of the reasonableness of the compensation. For example, the Sixth Circuit, citing the factors it set forth in the *Mayson*[55] case, found that a salary of $4.4 million paid to the president and sole shareholder of a corporation was reasonable even though the salary of the same individual had been $67,000 just four years before and had increased to just under $1 million for the previous year. The court concluded that in light of the effort the individual had put into the business after having started the company just eight years before, the record of success the individual had had with other companies, and the phenomenal growth and success of the new company, the individual had been grossly underpaid for several consecutive years and that the $4.4 million compensation for the year in question was not unreasonable.[56]

> **COMMENT**: The decision in *Alpha Medical*, discussed above, provides an opportunity for start-up companies to pay more to individuals whose hard work and expertise make a company successful. Documenting compensation paid in comparable industries and documenting an executive's expertise in a particular area should help to avoid the issue of unreasonable compensation.

Our Eighth Circuit[57] continues to apply the *Mayson* multi-factor test, discussed above.[58] Although the appellate court did not specifically mention independent investors, the Tax Court

[51] 249 F.3d 994 (10th Cir. 2001).
[52] 528 F.2d 176 (10th Cir. 1976).
[53] *Haffner's Service Stations, Inc. v. Commissioner*, No. 02-1761 (1st Cir. Mar. 31, 2003).
[54] See, e.g., *Leonard Pipeline Contractors, Ltd. v. Commissioner*, T.C. Memo. 1996-316, rev'd and remanded, 142 F.3d 1133 (9th Cir. 1998), supplemented on remand, T.C. Memo. 1998-315, aff'd, No. 98-71430 (9th Cir. Jan. 26, 2000).
[55] *Mayson Manufacturing Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949).
[56] *Alpha Medical Inc. v. Commissioner*, 172 F.3d 942 (6th Cir. 1999).
[57] *Charles Schneider & Co. v. Commissioner*, 500 F.2d 148 (8th Cir. 1974), aff'g T.C. Memo. 1973-130, cert. denied, 420 U.S. 908 (1975); Treas. Reg. § 1.162-7(b)(1).
[58] See footnote 40 and accompanying text.

decision in *Charles Schneider*[59] had stated that the lower court "seriously [doubted] whether salary agreements such as those before us would be permitted by completely independent shareholders."

Post *Exacto Spring*,[60] the Tax Court heard two reasonable compensation cases appealable to the Eighth Circuit. In Wagner Construction, Inc.[61] the court examined the nine factors from *Mayson* "from the perspective of an independent investor." The second case, *Miller & Sons Drywall, Inc.*,[62] also used the nine *Mayson* factors viewed through the lens of an independent investor. Accordingly, this standard is the one that should be met by taxpayers when defending reasonable compensation cases in the Eighth Circuit.

C. Shareholder Leases Farmland from Corporation

If a shareholder/employee has sufficient equipment and resources to farm, he may lease the farmland from his corporation at a fair cash rental rate and farm it himself. This limits the income that the corporation earns. Fair cash rental rates can be derived from the Iowa State University Extension Service at www.extension.iastate.edu/publications/fm1851.pdf.

D. The Exotic—Split Interest Purchase of Real Estate

If the C corporation is interested in acquiring real estate, it may want to consider purchasing a "split interest" in the real estate with one or more of its shareholders. A split interest in real estate requires at least two owners, one of which has a possessory and the other holding a nonpossessory interest. A common example is a life estate in the real estate followed by a remainder interest.

A C corporation and a shareholder can own a split interest in real estate. For example, a C corporation may desire to acquire a possessory interest in undeveloped real estate for a term of 35 years at the same time that its shareholder acquires the remainder interest. Assuming the real estate has a value of $1,000,000 at the time of acquisition, the present value tables set forth in Treasury Regulation 20.2031-7 (Table B) state that the cost to the C corporation would be $763,065 and the cost to the shareholder would be $236,935.[63] The interest factor to be used is the interest rate published by the IRS each month.[64] At the end of the 35-year term, the shareholder owns all right, title and interest to the real estate.

The unique and beneficial aspect of structuring an acquisition of a split interest of real estate by a C corporation and its shareholder is that the tax basis of the real estate gradually shifts from the C corporation to the shareholder with no tax consequences.[65] Thus, at the end of the 35

[59] T.C. Memo. 1973-130.
[60] See Footnote 49 and accompanying text.
[61] TCM 2001-160.
[62] TCM 2005-114.
[63] This example assumes a 4.2 percent interest rate which is the lowest rate published in the Table B.
[64] IRC § 7520. The December 2008 Section 7520 rate is 3.4 percent. Rev. Rul. 2008-53.
[65] Treas. Reg. § 1.1014-5(a)(3).

year term, the tax basis of the undeveloped real estate to the shareholder is $1,000,000, not the $236,935 that the shareholder actually paid. The result of the transaction is the distribution by the C corporation to the shareholder of $763,065, representing the purchase price paid by the C corporation.

The method to bail out the earnings and profits of a C-corporation as described above works best when unproductive property is purchased. If income producing property is acquired, the C-corporation will be legally entitled to the income during the term certain which may more than offset the C-corporation's purchase price of the property. The method also works better in high interest rate environments. If the IRS interest rate were 7.0 percent rather than the current 3.4 percent using the example above, the cost to the shareholder for the remainder interest would be $93,663 rather than $236,935.

A good candidate for such an acquisition may be Farm corporations acquiring farmland. Although farmland is generally considered income producing, the return on investment is generally very low. If a C corporation had to borrow funds to acquire the term interest in real estate, the cash flows are generally negative.

Electing Small Business Trust
Election by Trustee Under I.R.C. § 1361(e)(3)

Internal Revenue Service Center
[Address]

Re: **[ABC Corporation; Employer Identification Number]**
Electing Small Business Trust

This is an election to treated as an Electing Small Business Trust under IRC §1361(e)(3). This election is to become effective on **[Date]**, which is not earlier than two months and fifteen days before the filing of this election and which is the day on which ***select one:*****[the trust first owned shares of the corporation] [the corporation's election under IRC §1362 first became effective] [the corporation filed its election under IRC §1362]. Abc Corporation**, a **[State]** corporation in which the trust holds stock, has previously filed an election under IRC §1362(a). Stock of the corporation was transferred to the trust on **[date(s)]**.

As required by Internal Revenue Notice 97-12, the following information is provided:

Names, Addresses and Employer Identification Numbers

(a) Corporation: **[Name, address, Employer Identification Number]**
(b) Trust: **[Name, address, Employer Identification Number]**
(c) All Potential Current Beneficiaries:[66] **[Name, address, Employer Identification Number]**

The Trustee hereby represents that all Potential Current Beneficiaries are individuals and thereby meet the definitional requirements of I.R.C. § 1361(b)(1)(B). The Trustee further represents that all beneficiaries have received their interest by devise from a decedent and not by purchase, that the Trust has not elected to be treated as a qualified subchapter S trust as defined in I.R.C. § 1361(d)(3) and that the Trust otherwise meets the definitional requirements of an electing small business trust under I.R.C. § 1361(e).

[66] A potential current beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person, may receive, a distribution from the principal or income of the trust. I.R.S. Notice 97-49, 1997-36 I.R.B. 8.

Under penalties of perjury, the undersigned certifies that the trust meets the definitional requirements of
IRC §1361(e) and that all information provided in this election is true, correct and complete.

________ ______________________
Date [Trustee]