

REMOVING THE MASK: WHAT IS THE APPROPRIATE TEST FOR COURTS TO APPLY WHEN DETERMINING WHETHER COMPENSATION IS A DISGUISED DIVIDEND?

Daniel Hopper*

Pop Quiz: What do at least three major religions, the American Revolution, modern politics, and this comment all have in common? The answer: the topic of taxes.¹

I. INTRODUCTION

Alongside death, taxes are considered to be one of the few constants in life.² In fact, Supreme Court Justice Oliver Wendell Homes once said,

*Candidate for Juris Doctor 2017, Baylor University School of Law. I would like to thank all of the *Baylor Law Review* students that encouraged me while writing this comment and for the countless hours they spent reading and editing it. I would also like to thank Mr. Mark Snider and Professor Elizabeth Miller for simplifying the complex topic of federal tax law. Also, big thanks to Professor Jim Underwood who assisted me in making this comment readable. Lastly, I would like to thank my wife, Gretchen Hopper, for supporting me and reading far too many of my boring legal papers in our two and half years of marriage.

¹See *Matthew* 22:17-21 (New International) (“[The Pharisees’ disciples asked Jesus] ‘Is it right to pay the imperial tax to Caesar or not?’ . . . [Jesus] asked them, ‘Whose image is [on the coin used for paying taxes]? And whose inscription?’ ‘Caesar’s,’ they replied. Then He said to them, ‘So give back to Caesar what is Caesar’s, and to God what is God’s.’”) (Christianity); *Esther* 2:18 (English Standard) (“[The king] also granted a remission of taxes to the provinces and gave gifts with royal generosity.”) (Judaism); *Sahih Bukhari* 2:24:487 (“No Zakat [a charity tax] is due on property amounting to less than five Uqiyas, and no Zakat is due on less than five camels, and there is no Zakat on less than five Wasqs.”) (Islam); Sarah O’Brien, *Keep an Eye on Candidates’ Plans for Your Wallet: Advisors*, CNBC (July 11, 2016), <http://www.cnbc.com/2016/07/10/keep-eye-on-candidates-plans-for-your-wallet-advisors.html>; *No Taxation Without Representation*, LONDON MAG. 89, (Feb. 1768), <http://www.notationwithoutrepresentation.com/2012/09/no-taxation-without-representation.html>.

²See Daniel Defoe, *THE POLITICAL HISTORY OF THE DEVIL: AS WELL ANCIENT AS MODERN: IN TWO PARTS* 269 (1726) (“Things as certain as Death and Taxes, can be more firmly believed [sic] . . .”); see also Letter from Benjamin Franklin to Jean Baptiste Le Roy (Nov. 13, 1789), in *THE WRITINGS OF BENJAMIN FRANKLIN* 69 (Albert Henry Smyth, ed. 1907) (“Our new Constitution is now established, and has an appearance that promises permanency; but in this world *nothing can be said to be certain, except death and taxes.*”) (emphasis added).

“Taxes are what we pay for civilization.”³ At least, that is the noble intent behind taxes. In all actuality, however, the United States federal government does not have enough money to “pay for civilization.”

At the time of writing this comment, the federal income deficit is just shy of \$19.90 trillion, and growing by the second.⁴ The total deficit equates to a debt of more than \$61,000 per United States citizen and almost \$166,000 per United States taxpayer.⁵ Suffice it to say, the federal government has spent and continues to spend more money than it generates in income.⁶

Taxes and reforming the Internal Revenue Code of 1986, as amended, (IRC)⁷ were major issues in the 2016 presidential primary and general election. Bernie Sanders, a primary candidate for the Democratic Party, promised to drastically increase government programs, which in turn would require a drastic increase in tax revenue.⁸ On the other end of the political spectrum, Ted Cruz, a primary candidate for the Republican Party, promised to overhaul the IRC, and replace it with a flat-tax system.⁹ In the general election, the Democratic presidential nominee, Hillary Clinton, ran on a plan to increase the tax rates for estate tax liabilities.¹⁰ Obviously, these tax plans are nothing more than idle campaign promises (like nearly all

³Cole Smith, Note, *Life After Fior D'Italia: A New Proposal*, 65 LA. L. REV. 1265, 1290 (2005).

⁴U.S. DEBT CLOCK, <http://usdebtclock.org> (last visited May 2, 2017).

⁵*Id.*

⁶*See id.* For example, the federal tax revenue is currently a little over \$3.35 trillion. *Id.* This breaks down into about \$10,342 of revenue per citizen, and about \$27,993 of revenue per taxpayer. *Id.*

⁷*See generally* I.R.C. §§ 1–9834 (2012 & Supp. II 2014).

⁸Josh Barro, *Bernie Sanders's Tax Plan Would Test an Economic Hypothesis*, N.Y. TIMES (Feb. 9, 2016), <https://www.nytimes.com/2016/02/09/upshot/bernie-sanders-tax-plan-would-test-an-economic-hypothesis.html> (explaining that Sanders's tax plan would increase the combined tax rates for top income earners to about seventy-three percent).

⁹Josh Barro, *Ted Cruz's Simple, Radical Tax Plan*, N.Y. TIMES (Dec. 29, 2015), <https://www.nytimes.com/2015/12/29/upshot/ted-cruzs-simple-radical-tax-plan.html> (explaining that Cruz's plan would implement a ten percent flat tax rate on personal income and a sixteen percent flat tax rate on business income).

¹⁰Robert W. Wood, *Hillary Clinton's 65% Estate Tax Plan Overshadows Child Care Credit*, FORBES (Oct. 17, 2016), <http://www.forbes.com/sites/robertwood/2016/10/17/hillary-clintons-65-estate-tax-plan-overshadows-child-care-credit/#2eaa8ceb4fbf>.

campaign promises¹¹) by a woman and two men who failed to become the President of the United States.¹² Regardless of political affiliation, we can all agree that the federal government needs to either reduce its spending or increase its revenue, or both if it plans to reduce the budget deficit.¹³

One option for the federal government to increase its tax revenue is to deny deductions claimed by businesses taxed as corporations under Subchapter C of the IRC (C Corps) for the money given to their highly compensated shareholder-employees.¹⁴ When a C Corp gives large amounts of money to its shareholder-employees as wages or compensation to qualify for an income tax deduction, the compensation is called a disguised or constructive dividend.¹⁵ The United States Courts of Appeals disagree as to which method is the most appropriate approach to analyze an alleged disguised dividend. Some courts apply a test that considers multiple factors based on the particular facts and circumstances of each C Corp's case called the "Multi-Factor Test."¹⁶ Other courts apply a rebuttable presumption test based on a hypothetical shareholder's return on equity called the "Independent Investor Test."¹⁷

Assuming that the Internal Revenue Service (IRS) will increase its efforts to reallocate compensation as a disguised dividend to gain tax revenue, the courts should have a uniform test to determine whether an amount paid to a shareholder-employee is true compensation entitled to a

¹¹ See *Republican Party of Minn. v. White*, 536 U.S. 765, 780 (2002) ("[A]lthough one would be naive not to recognize that campaign promises are—by long democratic tradition—the least binding form of human commitment.").

¹² Amanda Marcotte, *Where the Campaigns of Ted Cruz and Bernie Sanders Meet: Examining the Fatal Flaw in Their Election Strategies*, SALON (May 4, 2016), http://www.salon.com/2016/05/04/where_the_campaigns_of_ted_cruz_and_bernier_sanders_meet_examining_the_fatal_flaw_in_their_election_strategies/; Laura Meckler, *Hillary Clinton's Shocking Loss to Donald Trump May Mark the End of a Path-Breaking Career*, WALL ST. J. (Nov. 9, 2016), <http://www.wsj.com/articles/hillary-clintons-shocking-loss-to-donald-trump-may-mark-the-end-of-a-path-breaking-career-1478707333>.

¹³ See *supra* note 6 and accompanying text.

¹⁴ See 33A AM. JUR. 2D *Federal Taxation* ¶ 16001 (2017). See generally *id.* ¶ 12027 ("A shareholder may receive a dividend even though no formal dividend is declared or paid to him, if it's determined that a corporate distribution was made primarily for the shareholder's benefit.").

¹⁵ See *id.* ¶ 12027.

¹⁶ See, e.g., *Foos v. Comm'r*, 41 T.C.M. (CCH) 863, 878–79 (1981) (mem. op.) (listing twenty-one factors for the court to consider in a disguised dividend case).

¹⁷ See *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 839 (7th Cir. 1999) ("When, notwithstanding the CEO's 'exorbitant' salary . . . the investors in his company are obtaining a far higher return than they had any reason to expect, his salary is presumptively reasonable.").

deduction or a dividend in disguise.¹⁸ This comment analyzes the two tests, and proposes a solution to cure the Court of Appeals split. Section II provides an overview of corporate tax law for C Corps, as well as summarizes the concept of disguised dividends. Section III will analyze the advantages and disadvantages of the Multi-Factor Test. Section IV will analyze the advantages and disadvantages of the Independent Investor Test. Lastly, Section V will recommend a uniform approach for the courts to apply, and address a few additional considerations regarding disguised dividends.

II. INTRODUCTION TO CORPORATE TAX AND DISGUISED DIVIDENDS

A. Overview of Corporate Tax Law¹⁹

“Decisions to embrace the corporate form of organization should be carefully considered, since a corporation is like a lobster pot: easy to enter, difficult to live in, and painful to get out of.”²⁰ The corporate tax “lobster pot” is difficult to live in because of the dreaded “double tax.”²¹ Corporations are taxed on their taxable income each year.²² This is the first level of tax.²³ Next, shareholders are taxed on any money distributed to the shareholders by the corporation, typically in the form of a dividend.²⁴ This

¹⁸This assumption is based on the rationale that the federal government wants to decrease its budget deficit, or at least decrease the rate in which the deficit is growing. *See supra* note 6 and accompanying text.

¹⁹The term “corporate tax” will refer to the taxation of C Corps (i.e., businesses subject to Subchapter C of the IRC). *See* I.R.C. §§ 301–385 (2012 & Supp. II 2014).

²⁰*Peracchi v. Comm’r*, 143 F.3d 487, 489 n.2 (9th Cir. 1998).

²¹*See* Michael Doran, *Mangers, Shareholders, and the Corporate Double Tax*, 95 VA. L. REV. 517, 525 (2009) (explaining that distributing business profits to a shareholder requires that the business “is taxed twice: once to the corporation and again to the shareholder.”); *see also* *Qualley v. Comm’r*, 35 T.C.M. (CCH) 887, 892 (1976) (“[T]he *double tax* normally paid when a corporation distributes its earnings and profits as dividends.”) (emphasis added).

²²I.R.C. § 11. For purposes of this comment, the tax rate for all corporations will be a flat rate at the highest tax rate for corporations in the IRC: thirty-five percent. *See id.*

²³*See id.*

²⁴*Id.* § 61 (“Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including . . . [d]ividends . . .”); *see also id.* § 316 (defining the term “dividend” as any distribution of property from the corporation to its shareholders out of its accumulated earnings and profits or out of the earnings and profits for the current taxable year).

is the second level of tax.²⁵ Hence, for a shareholder to get money out of the corporation, the IRS will take two bites out of the apple.

To illustrate the concept of the double tax, assume the following scenario: X Corp., a C Corp with only two shareholders, accumulates \$1,000,000 of profit this year, which is also the amount of its taxable income.²⁶ X Corp. will first be taxed at thirty-five percent.²⁷ Thus, after taxes, X Corp. will have \$650,000 remaining.²⁸ Assume that X Corp. decides to distribute all of this year's profits to its shareholders, so X Corp. will pay dividends of \$325,000 to both shareholder 1 and shareholder 2.²⁹ Thus, each shareholder will have to pay tax on \$325,000 at twenty percent.³⁰ Therefore, each shareholder will take home \$260,000.³¹ In summary, the \$1,000,000 of X Corp.'s profit was distributed in the following amounts: \$260,000 to shareholder 1, \$260,000 to shareholder 2, and \$480,000 to the IRS.³²

C Corps utilize many strategies to avoid the double tax system. One commonly used strategy is to reduce the C Corp's taxable income by increasing its deductible expenses.³³ Deductible expenses, or deductions, reduce a taxpayer's taxable income.³⁴ The general business deduction allows a taxpayer to deduct all expenses that are: (1) ordinary; (2) necessary; (3) expenses; (4) paid or incurred in during the taxable year;

²⁵ See *id.* § 1. For purposes of this comment, all dividends will qualify for capital gains treatment, and all capital gains will be taxed at twenty percent. See *id.* § 1(h)(1)(D) (explaining that the highest rate of a taxpayer's net capital gain is twenty percent, except as otherwise provided in § 11(h)).

²⁶ "Taxable income" means gross income minus allowable deductions. *Id.* § 63(a).

²⁷ See *supra* note 22.

²⁸ $\$1,000,000 * 0.35 = \$350,000$. See *supra* note 22. $\$1,000,000 - \$350,000 = \$650,000$.

²⁹ Assume that this distribution is a dividend, rather than a stock redemption. See I.R.C. § 301(c)(1) ("That portion of the distribution which is a dividend . . . shall be included in gross income."); see also *id.* § 302(a) ("If a corporation redeems its stock . . . and [one of § 302(b)(1)–(5)] applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.").

³⁰ *Id.* § 1(h)(11) (defining the term "qualified dividends", and explaining that qualified dividend income is included in "net capital gain"). See *supra* note 25.

³¹ $\$325,000 * 0.20 = \$65,000$. See *supra* note 25. $\$325,000 - \$65,000 = \$260,000$.

³² The IRS received \$350,000 from X Corp. See *supra* note 28. Additionally, the IRS received \$65,000 from each of the two shareholders. See *supra* note 31. $\$350,000 + \$65,000 + \$65,000 = \$480,000$.

³³ See I.R.C. § 63.

³⁴ *Id.*; see also *id.* § 161.

and (5) carrying on the taxpayer's trade or business.³⁵ Under Section 162, a C Corp is entitled to deduct reasonable "salaries or other compensation for personal services actually rendered."³⁶ Thus, unlike dividends, wages and compensation paid by a C Corp are deductible.³⁷

Returning to the hypothetical above, suppose now that shareholder 1 and shareholder 2 are also employees of X Corp. X Corp. still accumulates \$1,000,000 in income. In this scenario, X Corp. pays shareholder 1 and shareholder 2 each a salary of \$500,000. Therefore, X Corp.'s taxable income is zero.³⁸ For simplicity, assume that shareholder 1 and shareholder 2 are in the highest federal income tax bracket for individuals, so their \$500,000 will be taxed at thirty-nine and six-tenths percent (39.6%).³⁹ Thus, if the shareholders were taxed at a flat rate, then they would each take home \$302,000.⁴⁰ In summary, the distribution of the \$1,000,000 is as follows: \$302,000 to shareholder 1, \$302,000 to shareholder 2, and \$396,000 to the IRS.⁴¹

In this hypothetical, X Corp. and its shareholders avoid paying the IRS \$84,000 by simply giving the money to the shareholders as a salary instead of as a dividend.⁴² Additionally, X Corp. did not have to pay any income

³⁵ *Id.* § 162.

³⁶ *Id.*; *see also* Treas. Reg. § 1.162-7(a) (2016) ("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.")

³⁷ I.R.C. § 162; *see also* *Haffner's Serv. Stations, Inc. v. Comm'r*, 326 F.3d 1, 3 (1st Cir. 2003) ("[F]or the corporation that makes the payments, wages are deductible while dividends are not.")

³⁸ $\$1,000,000 - \$500,000 - \$500,000 = 0$.

³⁹ I.R.C. § 1 (a)-(d).

⁴⁰ $\$500,000 * 0.396 = \$198,000$. $\$500,000 - \$198,000 = \$302,000$. *But see id.* (providing a progressive rate for individuals, rather than a flat rate).

⁴¹ This hypothetical ignores state income taxes and/or payroll taxes. *See, e.g.*, CAL. REV. & TAX CODE ANN. § 23151(a) (West 2015) ("[E]very corporation doing business within the limits of [California] . . . shall annually pay to the state, for the privilege of exercising its corporate franchises within this state, a tax according to or measured by its net income"); *see also, e.g.*, I.R.C. § 3101(a) ("[T]here is hereby imposed on the income of every individual a tax equal to [6.2 percent] of the wages . . . received by [the individual] with respect to employment"). Generally, dividend distributions are not subject to payroll taxes, but wages and compensation are subject to payroll taxes. *See* Rev. Rul. 77-44, 1974-1 C.B. 287 (explaining that the shareholders attempted to avoid paying "employment taxes" by drawing no salary, but rather having the corporation issue what the shareholders would have received in compensation as a dividend).

⁴² $\$480,000 - \$396,000 = \$84,000$. *See supra* note 32.

tax at the C Corp level. Thus, X Corp. successfully avoided the double tax by paying its shareholder-employees a large salary. Perhaps this is why the median for chief executive officer's (CEO) salary for the past few years has been over \$10 million.⁴³ This type of deduction, however, encourages C Corps to manipulate the tax code by paying their shareholder-employees unreasonably high salaries.⁴⁴

B. Introduction to Disguised Dividends

As stated above, the IRC permits a deduction for reasonable salaries and other types of compensation.⁴⁵ The Department of Treasury's regulations (Treasury Regulations) provide in pertinent part: "The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services."⁴⁶ The Treasury Regulations further state that a reasonable compensation "is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."⁴⁷

Thus, if a C Corp pays a shareholder-employee an unreasonable compensation, then the corporation is not allowed to claim a deduction for that portion of the compensation.⁴⁸ The IRS is especially suspicious in the case of shareholder-employees in a small business receiving an unreasonable salary because of the perceived high probability that the small business is colluding with the shareholder to avoid paying taxes on dividends paid to its shareholders.⁴⁹

⁴³ Alessandria Masi, *CEO Median Pay Crosses \$10M: How Much Do CEOs Make And Who Are The Highest-Paid Female CEOs?*, INT'L BUS. TIMES (May 27, 2014, 9:21 PM), <http://www.ibtimes.com/ceo-median-pay-crosses-10m-how-much-do-ceos-make-who-are-highest-paid-female-ceos-1590883>.

⁴⁴ See *Haffner's Serv. Stations, Inc. v. Comm'r*, 326 F.3d 1, 3 (1st Cir. 2003) ("[T]here is an obvious incentive to disguise dividend distributions as compensation expenses.").

⁴⁵ I.R.C. § 162(a)(1); see also *supra* notes 36 and 37 and accompanying text.

⁴⁶ Treas. Reg. § 1.162-7(a) (2016).

⁴⁷ *Id.* § 1.162-7(b)(3).

⁴⁸ See *id.*

⁴⁹ See *id.* § 1.162-7(b)(1) ("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.") (emphasis added).

Hence, C Corps and the IRS play a cat-and-mouse game: the C Corp dresses up its dividends to look like compensation, and the IRS attempts to remove the mask and expose the underlying dividend.⁵⁰ What if, however, the compensation is not a disguised dividend?⁵¹ What if the shareholder-employee earns every penny of his or her large salary, and/or the salary is not unreasonably large or excessive? In those cases, the C Corp fights back in court.⁵² Simply stated, if the C Corp disagrees with the IRS's conclusion that compensation paid to a shareholder-employee is a disguised dividend, then the C Corp files a lawsuit challenging the IRS's decision.⁵³

Interestingly, the IRS almost exclusively plays the disguised dividend game with small businesses.⁵⁴ Perhaps this is because the IRS believes that

⁵⁰ See discussion *infra* Part III and Part IV. This strategy does not result in as much of a net decrease in tax for the C Corp and the shareholder-employees as it did before 2003. See Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302(a), 117 Stat. 760, 760–64 (amending I.R.C. § 1(h) tax qualified dividend income at capital gains rates). This amendment means that the shareholder-employee and the C Corp have an election to make: (1) pay a salary that is taxed at ordinary income rates for the shareholder-employee, but get a deduction; or (2) make a dividend that is taxed at a lower capital gains rate, but be subject to the double tax. See *Menard, Inc. v. Comm'r*, 560 F.3d 620, 622 (7th Cir. 2009) (“As a result of a change in law in 2003, dividends are now taxed at a lower maximum rate than salaries This makes the tradeoff more complex; although the corporation avoids tax by treating the dividend as a salary, which is deductible, the employee pays a higher tax.”).

⁵¹ An unreasonably large salary, as defined by a Treasury Regulation, is not necessarily treated as a disguised dividend. Treas. Reg. § 1.162-8 (2016) (“The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the [payer], will depend upon the circumstances of each case.”). This comment will assume that any amount deemed as an excessive or unreasonable salary will correspond or bear a close relationship to stockholdings (i.e. these amounts will automatically be disguised dividends). See *id.*

⁵² See, e.g., *Eberl's Claim Serv. v. Comm'r*, 249 F.3d 994, 999 (10th Cir. 2001); *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 839 (7th Cir. 1999); *Dexsil Corp. v. Comm'r*, 147 F.3d 96, 100 (2d Cir. 1998); *Owensby & Kritikos, Inc. v. Comm'r*, 819 F.2d 1315, 1323 (5th Cir. 1987); *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241, 1245–48 (9th Cir. 1983); *Mayson Mfg. Co. v. Comm'r*, 178 F.2d 115, 119 (6th Cir. 1949).

⁵³ Taxpayers have three options regarding lawsuits: (1) refuse to pay the tax and dispute a deficiency in Tax Court; (2) pay the tax and seek a refund in Federal District Court; or (3) pay the tax and seek a refund in Federal Claims Court. See SUSAN A. BERSON, FEDERAL TAX LITIGATION § 1.01 ¶ 24(a), (b) (2017).

⁵⁴ Treas. Reg. § 1.162-7(b)(1) (2016) (“This is likely to occur in the case of a corporation having few shareholders”); see also, e.g., *Menard*, 560 F.3d at 624 (analyzing a taxpayer who owns all the voting shares and 56% of the nonvoting shares, and his family owns the other 44% of nonvoting shares of stock); *Elliotts*, 716 F.2d at 1242 (analyzing a business with between eight and forty employees); *Irby Constr. Co. v. United States*, 290 F.2d 824, 826 (Ct. Cl. 1961) (“The

owners in a closely held corporation⁵⁵ are more likely to convince the other owners to conspire to pay less money in taxes—and there [is] no one to complain—except the [IRS].”⁵⁶ To believe this proposition, the IRS would have to turn a blind eye to all of the court cases addressing closely held corporations dealing with internal business turmoil, oppression, and bullying.⁵⁷ Perhaps it is because the big, public companies lobbied Congress enough to create a loophole freeing these companies from IRS scrutiny.⁵⁸ This argument, however, ignores that the Treasury Department, not Congress, has published regulations that solely focus on closely held corporations regarding disguised dividends.⁵⁹

Perhaps it is because, similar to what Judge Posner of the Seventh Circuit has implied, big companies have enough shareholders that will complain if a shareholder-employee is getting paid an unreasonably large

issue most often arises, as it does here, in a case concerning a close corporation, where the employees are also stockholders or members of a family controlling the corporation.”); *Foos v. Comm’r*, 41 T.C.M. (CCH) 863, 864 (1981) (analyzing a business with two shareholders).

⁵⁵This term is used generically to refer to a C Corp with a small number of shareholders in a privately held corporation, but without a specific minimum threshold number of shareholders. *Cf.* TEX. BUS. ORGS. CODE ANN. § 21.563(a) (West 2012) (defining “closely held corporation” as a Texas corporation that is privately owned by “fewer than 35 shareholders” and stock that is not publically traded).

⁵⁶*Menard*, 560 F.3d at 622.

⁵⁷*See, e.g., Ritchie v. Rupe*, 443 S.W.3d 856, 879 (Tex. 2014) (“[T]he foreseeability, likelihood, and magnitude of harm sustained by minority shareholders due to the abuse of power by those in control of a closely held corporation is significant, and Texas law should ensure that remedies exist to appropriately address such harm when the underlying actions are wrongful.”); Lydia Rogers, Comment, *The Bankruptcy Implications of a Court-Ordered Buyout for Shareholder Oppression: Is It a Remedy at All?*, 64 BAYLOR L. REV. 594, 594–95 (2012) (explaining that closely held corporations often start out friendly, but get hostile quickly, which leads to almost illegal actions).

⁵⁸*See* Mark Gongloff, *U.S. Companies Lobbying Furiously to Save Corporate Tax Loopholes: Study*, HUFFINGTON POST, June 18, 2013, http://www.huffingtonpost.com/2013/06/18/companies-lobbying-corporate-tax-loopholes-study_n_3461044.html (claiming that the “biggest U.S. corporations” have in the past, and continue today, to lobby Congress to maintain tax loopholes).

⁵⁹*See* Treas. Reg. § 1.162-7(b)(1) (“This is likely to occur in the case of a corporation having few shareholders . . .”). Accordingly, the courts have exclusively dealt with small closely held corporations. *See, e.g., Menard*, 560 F.3d at 624 (analyzing a taxpayer who owns all the voting shares and 56% of the nonvoting shares, and his family owns the other 44% of nonvoting shares of stock); *Irby*, 290 F.2d at 826 (“The issue most often arises, as it does here, in a case concerning a close corporation, where the employees are also stockholders or members of a family controlling the corporation.”).

salary.⁶⁰ This argument is also questionable. If the company is making enough money that the non-shareholder-employees are getting a good enough return, then it is doubtful that the CEO's salary will even cross the other shareholders' minds.

For example, consider the successful company Berkshire Hathaway Inc. (Berkshire).⁶¹ Berkshire does not pay its shareholders dividends.⁶² Over the past ten years, the lowest price for one share of Berkshire "A" stock was \$78,600.⁶³ As long as the stock price stays high and investors get a good rate of return, it is doubtful that an investor of Berkshire would care about a shareholder-employee's salary.⁶⁴ Moreover, unlike a closely held private corporation, an unhappy Berkshire shareholder can easily sell his or her shares whenever the company disappoints him or her.⁶⁵

Regardless of why the Department of Treasury chooses to focus on closely held C Corps, the courts must give *Chevron* deference to these administrative regulations.⁶⁶ Therefore, the courts are required to determine

⁶⁰ See *Menard*, 560 F.3d at 622.

⁶¹ See generally BERKSHIRE HATHAWAY INC., <http://www.berkshirehathaway.com> (last visited Mar. 30, 2017).

⁶² In fact, while Warren Buffett has been the CEO of Berkshire, 1967 is the only year that the company has distributed dividends. See *Why Doesn't Berkshire Hathaway Pay a Dividend?* (BRK-A, BRK-B), INVESTOPEDIA, <http://www.investopedia.com/ask/answers/021615/why-doesnt-berkshire-hathaway-pay-dividend.asp> (last updated Dec. 14, 2016).

⁶³ See Stock Summary of Berkshire Hathaway Inc. A, MSN, <http://www.msn.com/en-us/money/stockdetails?symbol=US:BRK.A> (last visited May 3, 2017). The highest point has been \$266,445 for one share of "A" stock. *Id.* Berkshire does have a more moderately priced "B" stock, which has a ten-year low of \$51.28 per share, and a ten year high of \$177.86 per share. See Stock Summary of Berkshire Hathaway Inc. B, MSN, <http://www.msn.com/en-us/money/stockdetails/fi-126.1.BRK%7CSLA%7CB.NYS.BRK.B> (last visited May 3, 2017).

⁶⁴ A change in Warren Buffett's salary, however, would turn several heads— it has remained \$100,000 for over a quarter of a century. Associated Press, *Billionaire Warren Buffett's Salary Remains Unchanged*, OMAHA WORLD-HERALD (Mar. 15, 2013), http://www.omaha.com/money/billionaire-warren-buffett-s-salary-remains-unchanged/article_af2eff07-6ab0-5ece-8114-87c8c8802dfd.html.

⁶⁵ *Ritchie v. Rupe*, 443 S.W.3d 856, 894 (Tex. 2014) (Guzman, J., dissenting) ("[T]here is no statutory right for a minority shareholder to exit . . . and receive a return of her investment. And frequently, the only buyers for minority shares of a closely held corporation are the remaining shareholders—who might be engaging in the oppressive conduct from which they could ultimately profit.").

⁶⁶ See *Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984) ("[T]he court does not simply impose its own construction on the statute . . . Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." (footnote omitted)); see also *Mayo*

when a salary is reasonable rather than ostensible.⁶⁷ The Treasury Regulations, however, fail to provide anything beyond vague and generic statements for how the court is to determine these issues.⁶⁸ Thus, because the courts must determine what is a reasonable salary and what is a disguised dividend, the courts turn to one of two main tests: the Multi-Factor Test and the Independent Investor Test.⁶⁹

III. THE MULTI-FACTOR TEST

A. Overview

The Multi-Factor Test is a test that involves multiple factors to evaluate the reasonableness of any given shareholder-employee's salary.⁷⁰ The Multi-Factor Test has been expressly adopted by five of the federal circuit courts.⁷¹ Accordingly, the Multi-Factor Test is the majority approach taken by the courts that have expressly adopted one of the two tests mentioned in this comment.

The Multi-Factor *Tests*—as opposed to the Multi-Factors Test—is perhaps a more appropriate title. In fact, various courts have applied more than twenty different enumerated factors, in several different

Found. for Med. Educ. & Research v. United States, 562 U.S. 44, 55 (2011) (“[W]e are not inclined to carve out an approach to administrative review good for tax law only. To the contrary, we have expressly recognized the importance of maintaining a uniform approach to judicial review The principles underlying our decision in *Chevron* apply with full force in the tax context.” (citations omitted) (internal quotation marks omitted)); 2 AM. JUR. 2D *Administrative Law* § 469 (2014) (“[C]ourts will generally show great deference to an agency’s interpretation of a statute. A reviewing court should accord considerable weight to an executive department’s construction of the statutory scheme it is entrusted to administer, and statutory interpretations by agencies with rulemaking powers deserve substantial deference.”) (footnotes omitted).

⁶⁷ See Treas. Reg. § 1.162-7(a), (b)(1) (2016).

⁶⁸ See *id.*

⁶⁹ See *supra* text accompanying notes 16–17.

⁷⁰ See *Haffner’s Serv. Stations, Inc. v. Comm’r*, 326 F.3d 1, 3 (1st Cir. 2003).

⁷¹ See *id.* at 4; see also *Eberl’s Claim Serv., Inc. v. Comm’r*, 249 F.3d 994, 999 (10th Cir. 2001); *Dexsil Corp. v. Comm’r*, 147 F.3d 96, 100 (2d Cir. 1998); *Owensby & Kritikos, Inc. v. Comm’r*, 819 F.2d 1315, 1323 (5th Cir. 1987); *Elliotts, Inc. v. Comm’r*, 716 F.2d 1241, 1245–48 (9th Cir. 1983); *Mayson Mfg. Co. v. Comm’r*, 178 F.2d 115, 119 (6th Cir. 1949).

combinations.⁷² No particular factor is mandatory and no particular factor is given more weight than any other factor.⁷³

In *Foos v. Commissioner*, the tax court attempted to identify most of the factors that Courts of Appeals had previously applied.⁷⁴ This resulted in a non-exhaustive list of twenty-one factors.⁷⁵ Specifically, the *Foos* court identified the following factors: (1) the shareholder-employee's qualifications and training; (2) the nature, extent, and scope of the shareholder-employee's duties; (3) the responsibilities and hours involved in the shareholder-employee's job; (4) the size and complexity of the business; (5) the results of the shareholder-employee's efforts; (6) the prevailing rates for comparable shareholder-employees in comparable business; (7) the scarcity of other qualified shareholder-employees; (8) the ratio of compensation to gross and net income of the business; (9) the salary policy of the employer to its other employees; (10) the amount of compensation paid to the shareholder-employee in prior years; (11) the shareholder-employee's responsibility for employer's inception and/or success; (12) the time of year the compensation was determined; (13) whether compensation was set by a board of directors; (14) the correlation between the stockholder-employees' compensation and his stockholdings; (15) the company's corporate dividend history; (16) the existence of a previously agreed upon contingent compensation formula prior to the rendition of services and based upon a free bargain between the employer and employee; (17) whether the shareholder-employee was under-compensated in prior years; (18) whether compensation was paid in accordance with a plan that has been consistently followed; (19) prevailing economic conditions; (20) whether the compensation was intended to induce the shareholder-employee to remain with the employer; and lastly (21) the financial condition of the company after payment of compensation.⁷⁶

⁷² See *Haffner's Serv. Stations*, 326 F.3d at 3; see also *Foos v. Comm'r*, 41 T.C.M. (CCH) 863, 878–79 (1981).

⁷³ See, e.g., *Irby Constr. Co. v. United States*, 290 F.2d 824, 826 (Ct. Cl. 1961); *Mayson Mfg. Co.*, 178 F.2d at 119 (“The situation must be considered as a whole with no single factor decisive.”).

⁷⁴ 41 T.C.M. (CCH) at 878–79 (“Courts have examined the following factors, among others, in determining whether [a shareholder-employee's] compensation is reasonable . . .”).

⁷⁵ *Id.*

⁷⁶ *Id.*

In contrast, other courts never list more than twelve factors when enumerating the factors of the Multi-Factor Test.⁷⁷ In theory, however, the analysis is the same regardless of the number of specified factors.⁷⁸ Thus, the Multi-Factor Test is designed to consider all relevant circumstances in each case.⁷⁹ In other words, the Multi-Factor Test is just a facts and circumstances test, with lists of potentially important facts or circumstances.⁸⁰ Although not expressly required, the Treasury Regulations seem to encourage the courts to utilize a facts and circumstances test in determining the reasonableness of a compensation package.⁸¹

⁷⁷ See, e.g., *Haffner's Serv. Stations*, 326 F.3d at 3 (“The Second Circuit offers a typical example of a short collection: the employee’s role, payments by comparable companies, nature and condition of the company (e.g., earnings), incentives to distort, and consistency of compensation within the company.”); *Eberl’s Claim Serv., Inc. v. Comm’r*, 249 F.3d 994, 999 (10th Cir. 2001) (“The factors to be considered have been ‘stated innumerable times’ but never reduced to a definitive list.” (quoting *Pepsi-Cola Bottling Co. of Salina v. Comm’r*, 528 F.2d 176, 179 (10th Cir. 1975))); *Elliotts, Inc. v. Comm’r*, 716 F.2d 1241, 1245–47 (9th Cir. 1983) (listing five factors: (1) role in the company; (2) external comparison; (3) character and condition of the company; (4) conflict of interest; and (5) internal consistency).

⁷⁸ See *Haffner's Serv. Stations*, 326 F.3d at 3 (“By and large, longer lists include elements that, in shorter ones, are grouped together.”).

⁷⁹ See *id.*

⁸⁰ *Mayson Mfg. Co. v. Comm’r*, 178 F.2d 115, 119 (6th Cir. 1949) (“Although every case of this kind must stand upon its own facts and circumstances, it is well settled that several basic factors should be considered by the Court in reaching its decision in any particular case.”); *Webb & Bocorselski, Inc. v. Comm’r*, 1 B.T.A. 871, 874 (1925) (“We must examine the facts and determine whether there is any reason why the rules should be qualified in the light of the peculiar facts in this appeal.”).

⁸¹ Compare Treas. Reg. § 1.162-7(b)(3) (2016) (“In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.”), with *id.* § 1.162-8 (“The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the [payer], will depend upon the circumstances of each case.” (emphasis added)).

B. Advantages of the Multi-Factor Test

1. The Multi-Factor Test Provides Flexibility and Room for Advocacy

The Multi-Factor Test is a flexible test. As mentioned above, the courts have provided as many as twenty-one different factors.⁸² Although some factors are often used, the courts rarely apply all of the same factors.⁸³ Additionally, some courts prefer fewer factors that are broader rather than many specific factors.⁸⁴ Moreover, the courts are not supposed to favor one factor over any other factor.⁸⁵ Thus, courts can articulate the test in several different ways to ensure that it accurately determines the reasonableness of a shareholder-employee's compensation.⁸⁶

For example, returning to the X Corp. hypothetical, suppose that shareholder 1 and shareholder 2 are attempting to pay as little tax as possible.⁸⁷ The two shareholders are aware that the IRS is likely to

⁸² See *Foos v. Comm'r*, 41 T.C.M. (CCH) 863, 878–79 (1981).

⁸³ See, e.g., *Eberl's Claim Serv., Inc. v. Comm'r*, 249 F.3d 994, 999 (10th Cir. 2001) (“The factors to be considered have been stated innumerable times but never reduced to a definitive list.” (internal quotation marks omitted)).

⁸⁴ Compare *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241, 1245–48 (9th Cir. 1983) (listing the relevant factors as: (1) role in the company; (2) external comparison; (3) character and condition; (4) conflict of interest; and (5) internal consistency), with *Mayson Mfg. Co.*, 178 F.2d at 119 (6th Cir. 1949) (listing the relevant factors as: (1) shareholder-employee's qualifications; (2) the nature, extent and scope of the employee's work; (3) the size and complexities of the business; (4) comparison of the salaries paid with the gross income and the net income of the business; (5) the general economic conditions; (6) comparison of salaries with distributions to stockholders; (7) the prevailing rates of compensation for comparable positions in comparable concerns; (8) the salary policy of the business as to all of its employees; and (9) the amount of compensation paid to the particular shareholder-employee in previous years).

⁸⁵ *Mayson Mfg. Co.*, 326 F.3d at 119 (“The situation must be considered as a whole with no single factor decisive.”); see also *Irby Constr. Co. v. United States*, 290 F.2d 824, 826 (Ct. Cl. 1961) (“[N]o one fact can be considered controlling to the exclusion of all others. Each situation must be examined as a whole.” (citation omitted)).

⁸⁶ See *Haffner's Serv. Stations, Inc. v. Comm'r*, 326 F.3d 1, 4 (1st Cir. 2003) (rejecting the Independent Investor Test because “[t]here is always a balance to be struck between simplifying doctrine and accuracy of result, and for the present we think that multiple factors often may be relevant.”).

⁸⁷ Additionally, assume that shareholder 1 and shareholder 2 do not want to be fined up to \$100,000 and/or be imprisoned for up to five years. See I.R.C. § 7201 (2012) (listing the criminal sentences for tax evasion).

scrutinize X Corp.'s tax return.⁸⁸ Therefore, the two shareholders attempt to structure X Corp.'s transactions in such a way that will convince the IRS, and potentially a court, into believing that a large sum of money paid to the shareholders is not a disguised dividend.⁸⁹

If the test for reasonableness was rigid and strictly defined, then the two shareholders could easily manipulate the test and avoid paying the double tax.⁹⁰ In contrast, the Multi-Factor Test allows for the IRS to argue that shareholder 1 and 2's compensation is actually a disguised dividend, despite the fact that the X Corp. took great strides to dress up the dividend.⁹¹ By the same token, the Multi-Factor Test will allow a shareholder-employee to argue that his or her compensation is not a disguised dividend, despite the fact that the compensation is unusually large.⁹² Therefore, the Multi-Factor Test provides lawyers the opportunity to advocate and attempt to persuade the fact finder on the issue of reasonableness.

2. The Multi-Factor Test Provides More Case Law and Persuasive Authority

The Multi-Factor Test is the majority approach for the federal circuit courts.⁹³ As such, more cases exist where a court used the Multi-Factor Test than cases where a court used the Independent Investor Test.⁹⁴ Thus, the Multi-Factor Test has greater precedential value at the district court and at the tax court levels.⁹⁵ Additionally, the cases may serve as persuasive

⁸⁸ See *supra* note 54.

⁸⁹ Although completely hypothetical, this situation is most likely accurate given the obvious benefit: "[B]y reducing corporate taxes, more [money] accrues to the shareholders." *Haffner's Serv. Stations*, 326 F.3d at 3.

⁹⁰ See *id.*

⁹¹ See *Mayson Mfg. Co. v. Comm'r*, 178 F.2d 115, 119 (6th Cir. 1949).

⁹² "The fact that a payment may be highly unusual does not prevent its being an ordinary and necessary business expense." *Williams & Waddell, Inc. v. Pitts*, 148 F. Supp. 778, 781 (E.D.S.C. 1957) (analyzing whether payments pursuant to a highly unusual contract were disguised dividends under I.R.C. § 162).

⁹³ See *supra* note 71.

⁹⁴ Compare *Eberl's Claim Serv., Inc. v. Comm'r*, 249 F.3d 994, 999 (10th Cir. 2001) (citing cases decided by three other circuits and the tax court in support of the Multi-Factor Test), with *Menard, Inc. v. Comm'r*, 560 F.3d 620, 623–24 (7th Cir. 2009) (citing only one case not from the Seventh Circuit in support of the Independent Investor Test (citing *United States v. Borer*, 412 F.3d 987, 992 (8th Cir. 2005))).

⁹⁵ Under the *Golsen* Rule, the tax court will follow the law of the circuit court that the taxpayer would appeal the tax court's decision to. See *Golsen v. Comm'r*, 54 T.C. 742, 757

authority when attempting to convince a fact finder of the reasonableness, or lack thereof, of a shareholder-employee's salary.

Moreover, the Multi-Factor Test can improve and evolve with more cases and judicial interpretations. For example, the Independent Investor Test was first introduced in a case where the court applied the Multi-Factor Test.⁹⁶ In *Elliotts, Inc. v. Commissioner*, the Ninth Circuit followed a Multi-Factor Test, listing five broad factors to be considered.⁹⁷ The court explained, however, that the factors should be considered through the prospective of a hypothetical independent investor of the business in question.⁹⁸ The *Elliotts* court recognized that the five factors should be considered through the eyes of a hypothetical independent investor because that payment to the shareholder-employee would noticeably decrease the investor's rate of return.⁹⁹ Since *Elliotts*, other circuit courts have also recognized the importance of a hypothetical investor's rate of return in connection with the other factors.¹⁰⁰

3. The Multi-Factor Test Is Consistent with Other Tax Rules and Regulations

As mentioned above, the Treasury Regulations suggest, but do not explicitly require, that courts should consider all the facts and circumstances when determining the reasonableness of a shareholder-employee's compensation.¹⁰¹ Thus, a court applying the Multi-Factor Test can be confident that it is giving *Chevron* deference to the Treasury

(1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971) (“[I]t is our best judgment that better judicial administration. [sic] requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone.” (footnote omitted)).

⁹⁶ See *Elliotts, Inc. v. Comm’r*, 716 F.2d 1241, 1245 (9th Cir. 1983).

⁹⁷ *Id.* at 1245–47.

⁹⁸ *Id.* at 1245 (“A relevant inquiry is whether an inactive, independent investor would be willing to compensate the employee as he was compensated.”).

⁹⁹ See *id.* at 1245, 1248 (“A formula [on employee compensation] which would not allow a reasonable return on equity [to the independent investor] is likely to be unreasonable.”).

¹⁰⁰ See, e.g., *Dexsil Corp. v. Comm’r*, 147 F.3d 96, 101 (2d Cir. 1998) (“[T]he [I]ndependent [I]nvestor [T]est is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed.”); see also *Haffner’s Serv. Stations, Inc. v. Comm’r*, 326 F.3d 1, 4 (1st Cir. 2003) (explaining that the Independent Investor Test provides a useful reminder that § 162 “is not a moral concern or a matter of fairness; the inquiry aims at what an arm’s-length owner would pay an employee for his work.”).

¹⁰¹ See *supra* note 81.

Regulations.¹⁰² Additionally, the Multi-Factor Test is consistent with other tax rules and regulations.¹⁰³ Under Section 162, facts and circumstances tests are extremely common when determining if a business expense qualifies for a deduction.¹⁰⁴ Thus, courts are usually considering multiple facts and circumstances when deciding cases regarding the deductibility of an expense.

C. Disadvantages of the Multi-Factor Test

1. The Factors Specified Are Vague, Highly Intertwined, and Difficult to Apply

The Multi-Factor Test is designed to accurately determine whether a shareholder-employee's compensation is reasonable, without limiting the court to possible factors to consider.¹⁰⁵ Although listing factor after factor may result in the test appearing more superior to a more simply stated test, many of the factors are vague, interconnected, and/or illogical.¹⁰⁶ Therefore, the factors are actually unhelpful to the courts.¹⁰⁷

¹⁰² See *Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984) (“[T]he court does not simply impose its own construction on the statute Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency’s answer is based on a permissible construction of the statute.” (footnote omitted)).

¹⁰³ See, e.g., Treas. Reg. § 1.183-2(b) (2016) (listing nine factors that are “normally taken into account” when determining whether the taxpayer engages in an activity for profit, but explaining that “all facts and circumstances with respect to the activity are to be taken into account” and “[n]o one factor is determinative in making this determination.”); *id.* § 1.302-2(b)(1) (“The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends on the facts and circumstances of each case.”); Temp. Treas. Reg. § 1.469-5T(a)(7), (b) (2016) (permitting the taxpayer to rely on a facts and circumstances test to show that the taxpayer materially participates in an activity to avoid passive loss limitations).

¹⁰⁴ See, e.g., Treas. Reg. § 1.162-2(b)(2) (applying a facts and circumstances test when determining if a trip is primarily for business or for personal activities); *id.* § 1.162-32(a) (applying a facts and circumstances test when determining whether local lodging expenses are paid or incurred in carrying on a taxpayer’s trade or business).

¹⁰⁵ See *Haffner’s Serv. Stations, Inc. v. Comm’r*, 326 F.3d 1, 4 (1st Cir. 2003) (“There is always a balance to be struck between simplifying doctrine and accuracy of result, and for the present we think that multiple factors often may be relevant.”); see also *supra* notes 75 and 76.

¹⁰⁶ See, e.g., *Menard, Inc. v. Comm’r*, 560 F.3d 620, 622–23 (7th Cir. 2009).

¹⁰⁷ See *id.*

For example, some of the factors include, among other things: (1) the size of the C Corp; (2) the complexity of the C Corp; and (3) a number of fiscal and financial information about the C Corp.¹⁰⁸ First off, the IRS primarily focuses on closely held C Corps when it claims that a shareholder-employee's compensation is a disguised dividend.¹⁰⁹ Therefore, courts will be applying the Multi-Factor Test almost exclusively to small businesses.¹¹⁰ Nevertheless, the size of the business is a factor in the Multi-Factor Test applied to these small businesses.¹¹¹ Presumably, this factor creates the following rule regarding the reasonableness of a shareholder-employee's compensation: the smaller the business, the smaller the salary.¹¹² Thus, the C Corp will find itself on the IRS's radar if it is too small to avoid scrutiny on this issue, and then the fact that the C Corp has few shareholders will be counted against the business again in the Multi-Factor Test.¹¹³

Second, the size of the business and the business finances can be interconnected. For example, assume that X Corp. is a brand new small business. Additionally, assume that X Corp.'s net income is nominal, or maybe even a net loss.¹¹⁴ X Corp. only pays a modest salary to its shareholder-employees and pays them all the same amount. Statistically, X Corp. is most likely not going to be a successful, sustainable business.¹¹⁵ Based on the Multi-Factor Test, a reasonable salary for the shareholder-

¹⁰⁸Financial factors include, for example, dividend history, the C Corp's gross and net income, salary to other employees, and to other shareholder-employees. *See* *Foos v. Comm'r*, 41 T.C.M. (CCH) 863, 878 (1981).

¹⁰⁹*See supra* Section II.B.

¹¹⁰*See, e.g., Owensby & Kritikos, Inc. v. Comm'r*, 819 F.2d 1315, 1322 (5th Cir. 1987) ("For large, publicly held corporations, the deductibility of compensation is seldom questioned, because the corporation is usually dealing at arm's length with its employees. In a small, closely held corporation, however, the issue arises more frequently.").

¹¹¹*See Foos*, 41 T.C.M. (CCH) at 878.

¹¹²*See Owensby & Kritikos*, 819 F.2d at 1322; *see also Menard*, 560 F.3d at 628 ("The Tax Court's opinion [pursuant to the Multi-Factor Test] strangely remarks that because Mr. Menard owns the company he has all the incentive he needs to work hard, without the spur of a salary. In other words, reasonable compensation for Mr. Menard might be zero.").

¹¹³*See Foos*, 41 T.C.M. (CCH) at 878; *see also Owensby & Kritikos*, 819 F.2d at 1322.

¹¹⁴"Net income" means revenue minus expenses, depreciation, interest, and taxes. *Net Income – NI*, INVESTOPEDIA, <http://www.investopedia.com/terms/n/netincome.asp> (last visited Oct. 3, 2016).

¹¹⁵Eric T. Wagner, *Five Reasons 8 Out of 10 Businesses Fail*, FORBES (Sept. 12, 2013), <http://www.forbes.com/sites/ericwagner/2013/09/12/five-reasons-8-out-of-10-businesses-fail/#6560cefa5e3c> (providing reasons why approximately 80% of new businesses fail).

employees of X Corp. might be zero or some other nominal amount. Accordingly, the Multi-Factor Test would have the court re-characterize the modest salaries as a disguised dividend.

Similarly, factors such as the shareholder-employee's qualifications, efforts, duties, success, and working hours are all redundant. The cases do not specify what these factors mean; for example, the cases are not entirely clear whether a successful business is a positive factor or a negative factor. Moreover, despite what many disgruntled employees may believe, it is very unlikely that employing an unqualified executive will result in a successful enterprise. Likewise, if a shareholder-employee is maximizing his or her efforts, working long hours, and performing a lot of duties, then the business is likely to be successful. Overall, these factors seem to guard against a C Corp giving someone (i.e., a family member or close friend) an executive title just to give that person a large amount of money and have the C Corp take a deduction for it.¹¹⁶ Thus, it takes courts five factors to determine what Congress described in five words.¹¹⁷

Furthermore, the factors include a comparison of salaries with comparable positions, whether there is a scarcity of qualified individuals, and the general economic conditions of the tax year or years in question.¹¹⁸ All of the factors sound logical, but upon further review they are puzzling.¹¹⁹ Comparing one CEO's salary with other similarly situated CEO's, for example, makes perfect sense. In fact, the Treasury Department believes it is safe to assume that a reasonable compensation for an employee is what other employers would ordinarily pay that employee for

¹¹⁶ See I.R.C. § 162(a)(1) (2012 & Supp. II 2014) ("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 . . . a reasonable allowance for salaries or other compensation for personal services actually rendered . . .").

¹¹⁷ See *id.* ("[F]or personal services *actually rendered* . . .") (emphasis added)).

¹¹⁸ See *Foos*, 41 T.C.M. (CCH) at 878.

¹¹⁹ See *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 835 (7th Cir. 1999) ("Suppose that an employee who let us say was . . . a founder and the chief executive officer and principal owner of the taxpayer rendered no services at all but received a huge salary. It would be absurd to allow the whole or for that matter any part of his salary to be deducted as an ordinary and necessary business expense even if he were well qualified to be CEO of the company, the company had substantial net earnings, CEOs of similar companies were paid a lot, and it was a business in which high salaries are common.").

like services.¹²⁰ The average CEO's salary, however, is almost 150 times higher than the average household income.¹²¹

Additionally, if the shareholder-employee is the only qualified individual to serve in a particular position, does that mean the shareholder-employee's high salary is reasonable or unreasonable? Assume that the economy is performing poorly, but X Corp. is one of the few companies making money. Under the Multi-Factor Test, is X Corp. expected to reduce its shareholder-employee's salary?¹²² To summarize, the Multi-Factor Test is redundant, ambiguous, and confusing.¹²³

2. The Multi-Factor Test Is Unhelpful, Nondirective, and Not Objective

In *Exacto Spring Corporation v. Commissioner*, Judge Posner articulated several disadvantages of the Multi-Factor Test.¹²⁴ In *Exacto Spring*, a closely held C Corp paid its CEO \$1.3 million in 1993 and \$1 million in 1994.¹²⁵ The IRS considered the CEO's salary excessive and reallocated \$919,000 as a dividend in 1993 and \$600,000 as a dividend in 1994.¹²⁶ The tax court applied the Multi-Factor Test and concluded that only \$400,000 was a dividend in 1993 and \$300,000 was a dividend in 1994.¹²⁷ The CEO then appealed to the Seventh Circuit Court of Appeals.¹²⁸

Judge Posner, writing for the Seventh Circuit, first noted that the Multi-Factor Test is a nondirective test.¹²⁹ The Seventh Circuit observed that the courts do not assign a particular weight to any specific factors.¹³⁰ If no factor is given more weight than any other factor, then the Multi-Factor

¹²⁰Treas. Reg. § 1.162-7 (b)(3) (2016).

¹²¹See Masi, *supra* note 43; see also Carmen DeNavas-Walt & Bernadette D. Proctor, *Income and Poverty in the United States: 2014*, U.S. CENSUS BUREAU (2015), <https://www.census.gov/content/dam/Census/library/publications/2015/demo/p60-252.pdf> (stating that the average household income in 2014 was \$68,426).

¹²²See *Foos*, 41 T.C.M. (CCH) at 878–79.

¹²³See *Palmer v. City of Chi.*, 806 F.2d 1316, 1318 (7th Cir. 1986) (“[A]s with so many multi-’pronged’ legal tests it manages to be at once redundant, incomplete, and unclear.”).

¹²⁴See 196 F.3d at 835–36.

¹²⁵*Id.* at 834.

¹²⁶See *id.*

¹²⁷See *id.*

¹²⁸See *id.*

¹²⁹See *id.* at 835.

¹³⁰See *id.*

Test does not assist the court when a salary is not obviously reasonable or not obviously unreasonable.¹³¹ Second, the court found that the factors are not clearly related to each other, nor do the factors clearly relate to the primary purpose of I.R.C. § 162.¹³² Essentially, the *Exacto Spring* court's criticism is that the factors really limit fact finders from considering all of the facts and circumstances.¹³³ Thus, courts must either ignore other relevant facts or consider those relevant facts regardless of what the listed factors are.

Another disadvantage of the Multi-Factor Test is that the test gives courts the powers to make decisions related to the inner workings of the C Corp.¹³⁴ The Seventh Circuit explained that it has a policy against acting as a "superpersonnel department" that reexamines the decisions businesses make.¹³⁵ Other courts have adopted similar policies regarding other aspects of corporate law.¹³⁶ The *Exacto Spring* court suggested that judges are not qualified to set the salaries for corporate executives.¹³⁷ Indeed, there is a large salary discrepancy between federal judges and CEOs. The salary for a federal judge in 2016 begins at \$203,100 for a district court judge and goes as high as \$260,700 for the Chief Justice of the Supreme Court of the United States.¹³⁸ Thus, nearly all CEOs' salaries are considered "exorbitant" when compared to the salary of a federal judge.¹³⁹

¹³¹ *See id.* ("No indication is given of how the factors are to be weighed in the event they don't all line up on one side."); *see also supra* note 85 and accompanying text.

¹³² *Id.* ("[T]he factors do not bear a clear relation either to each other or to the primary purpose of [§ 162], which is to prevent dividends . . . which are not deductible from corporate income, from being disguised as salary . . .").

¹³³ *See id.*

¹³⁴ *See id.* ("[The Multi-Factor Test] invites the Tax Court to set itself up as a superpersonnel department for closely held corporations . . .").

¹³⁵ *See id.*; *see also* Jackson v. E.J. Brach Corp., 176 F.3d 971, 984 (7th Cir. 1999).

¹³⁶ *See* Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996) ("[A] court, acting responsibly, ought not to subject a corporation to the risk, expense and delay of derivative litigation, simply because a shareholder asserts, even sincerely, the belief and judgment that the corporation wasted corporate funds by paying far too much."); *see also* Sneed v. Webre, 465 S.W.3d 169, 178 (Tex. 2015) ("[T]he business judgment rule protects corporate officers and directors from being held liable to the corporation for . . . actions that are negligent, unwise, inexpedient, or imprudent if the actions were within the exercise of their discretion and judgment . . ." (internal quotation marks omitted)).

¹³⁷ *See* 196 F.3d at 835.

¹³⁸ *Judicial Compensation*, U.S. COURTS, <http://www.uscourts.gov/judges-judgeships/judicial-compensation#fn1> (last visited Apr. 2, 2017).

¹³⁹ *See Exacto Spring*, 196 F.3d at 839.

Additionally, and perhaps most importantly, the Multi-Factor Test is not objective.¹⁴⁰ Rather, the test invites the courts to make arbitrary decisions.¹⁴¹ As mentioned above, the factors are vague and often provide no guidance to the courts.¹⁴² Additionally, the factors may be conflicting and redundant.¹⁴³ Therefore, a court is forced to determine how much money is reasonable for any particular shareholder-employee, and then claim that the determination was based on the Multi-Factor Test.¹⁴⁴ Lastly, the court's version of a reasonable shareholder-employee's salary is unpredictable.¹⁴⁵ In conclusion, the Multi-Factor Test prevents C Corps from effectively engaging in business and tax planning. Nor can a shareholder-employee be confident that his or her salary will be respected as true compensation. Instead, the business and its shareholder-employees have to wait to see which judge hears the case, on what day the case is heard, and the judge's sympathy towards highly compensated individuals.¹⁴⁶

IV. THE INDEPENDENT INVESTOR TEST

A. Overview of the Independent Investor Test

The Independent Investor Test is a method of determining the reasonableness of a shareholder-employee's salary that attempts to be consistent with economic principles. As mentioned above, the Seventh Circuit was highly critical of the Multi-Factor Test in *Exacto Spring*.¹⁴⁷ It should come as no surprise that the court found an avenue to avoid utilizing

¹⁴⁰ See *id.* at 835.

¹⁴¹ See *id.*

¹⁴² See *supra* Part III.C.1.

¹⁴³ See *supra* Part III.C.1.

¹⁴⁴ See, e.g., *Exacto Spring*, 196 F.3d at 835 (noting that “[o]ne would have to be awfully naive” to believe the tax court “cut the baby in half” between the IRS’ perceived reasonable salary for the taxpayer and the taxpayer’s perceived reasonable salary based on the factors in the Multi-Factor Test). Additionally, an appellate court must review the lower court’s fact determination on this issue by a clearly erroneous standard. See *Haffner’s Serv. Stations, Inc. v. Comm’r*, 326 F.3d 1, 3 (1st Cir. 2003); see also FED. R. CIV. P. 52(a)(6) (“Findings of fact, whether based on oral or other evidence, must not be set aside unless clearly erroneous, and the reviewing court must give due regard to the trial court’s opportunity to judge the witnesses’ credibility.”).

¹⁴⁵ See *Exacto Spring*, 196 F.3d at 835.

¹⁴⁶ See *id.*

¹⁴⁷ See *supra* Part III.C.2.

the Multi-Factor Test.¹⁴⁸ Instead, the court explained that C Corps should be analyzed as:

[A] contract in which the owner of assets hires a person to manage them. The owner pays the manager a salary and in exchange the manager works to increase the value of the assets that have been entrusted to his management; that increase can be expressed as a rate of return to the owner's investment. The higher the rate of return (adjusted for risk) that a manager can generate, the greater the salary he can command. If the rate of return is extremely high, it will be difficult to prove that the manager is being overpaid, for it will be implausible that if he quit if his salary was cut, and he was replaced by a lower-paid manager, the owner would be better off; it would be killing the goose that lays the golden egg.¹⁴⁹

In other words, this test simply asks whether a hypothetical independent investor is getting a return on investment far higher than he or she would have any reason to expect.¹⁵⁰ If the answer is yes, then the shareholder-employee's salary is presumptively reasonable and thus is presumptively not a disguised dividend.¹⁵¹

Under the Independent Investor Test, determining the hypothetical rate of return does not end the court's analysis.¹⁵² Instead, the government is given a chance to rebut the presumption.¹⁵³ The courts have provided a few examples for situations that could potentially rebut the presumption. These examples include: (1) the business's profit is directly due to extrinsic factors, such as the unexpected discovery of oil on the C Corp's real

¹⁴⁸ See *Exacto Spring*, 196 F.3d at 838–39.

¹⁴⁹ *Id.* at 838.

¹⁵⁰ See *id.* at 839.

¹⁵¹ See *id.* (“We say ‘presumptively’ because we can imagine cases in which the return, though very high, is not due to the CEO’s exertions.”).

¹⁵² See *id.* at 839.

¹⁵³ See *id.* (“Suppose *Exacto* had been an unprofitable company that suddenly learned that its factory was sitting on an oil field, and when oil revenues started to pour in its owner raised his salary from \$50,000 a year to \$1.3 million. The presumption of reasonableness would be rebutted.”); see also *Menard, Inc. v. Comm’r*, 560 F.3d 620, 623 (7th Cir. 2009) (“But we added that the presumption could be rebutted by evidence that the company’s success was the result of extraneous factors, such as an unexpected discovery of oil under the company’s land, or that the company intended to pay the owner/employee a disguised dividend rather than salary.”).

property;¹⁵⁴ (2) the shareholder-employee's position in the company is merely a title;¹⁵⁵ (3) the shareholder-employee did not actually work for the company;¹⁵⁶ (4) evidence of a conflict of interest;¹⁵⁷ and (5) the relationship between the shareholder-employee's compensation and the compensation of other executives—especially if the executives are not shareholders.¹⁵⁸

Although *Exacto Spring* was the first opinion that expressly replaced the Multi-Factor Test with the Independent Investor Test, other courts had previously considered business transactions through the lens of an independent investor.¹⁵⁹ In fact, the *Exacto Spring* court cited *Elliotts*¹⁶⁰ and *Dexsil*¹⁶¹ as adopting the Independent Investor Test.¹⁶² As discussed above, these courts claimed to apply the Multi-Factor Test through the lens of an independent investor.¹⁶³ The *Exacto Spring* court, however, was convinced that these cases actually adopted a *new test* (i.e., the Independent Investor Test): “[J]udges tend to downplay the element of judicial creativity in adapting laws to fresh insights and changed circumstances But that is a

¹⁵⁴ *Mulcahy, Pauritsch, Salvador & Co. v. Comm’r*, 680 F.3d 867, 871 (7th Cir. 2012); *Menard*, 560 F.3d at 623 (explaining that success was caused by extrinsic factors, such as an unexpected discovery of oil under the company’s land); *Exacto Spring*, 196 F.3d at 839 (providing an example where the business was located on an oil field).

¹⁵⁵ *See Exacto Spring*, 196 F.3d at 839 (“There is no suggestion of anything of that sort here and likewise no suggestion that Mr. Heitz was *merely the titular chief executive* and the company was actually run by someone else, which would be another basis for rebuttal.” (emphasis added)).

¹⁵⁶ *Id.*; *see also Menard*, 560 F.3d at 623 (“The strongest ground for rebuttal, which brings us back to the basic purpose of disallowing ‘unreasonable’ compensation, is that the employee does no work for the corporation; he is *merely* a shareholder.” (quoting *Exacto Spring*, 196 F.3d at 839)).

¹⁵⁷ *Menard*, 560 F.3d at 623 (noting that evidence of a conflict of interest is not always decisive).

¹⁵⁸ *See id.*; *see also Mulcahy*, 680 F.3d at 871.

¹⁵⁹ *See, e.g., Scriptomatic, Inc. v. United States*, 555 F.2d 364, 367–68 (3d Cir. 1977) (stating that whether an outside investor would have advanced funds on terms and conditions similar to the terms and conditions associated with the funds advanced by the shareholder is a factor when the court determines whether money given to the corporation by a shareholder truly represents a debt).

¹⁶⁰ *See generally Elliotts, Inc. v. Comm’r*, 716 F.2d 1241 (9th Cir. 1983).

¹⁶¹ *See generally Dexsil Corp. v. Comm’r*, 147 F.3d 96 (2d Cir. 1998).

¹⁶² *See Exacto Spring*, 196 F.3d at 838 (“The federal courts of appeals, whose decisions do of course have weight as authority with us even when they are not our own decisions, have been moving toward a much simpler and more purposive test, the ‘independent investor’ test. We applaud the trend and join it.” (citations omitted)).

¹⁶³ *See supra* note 100 and accompanying text.

formality. The new test dissolves the old and returns the inquiry to basics.”¹⁶⁴

B. Advantages of the Independent Investor Test

1. The Independent Investor Test is Objective

Like a snowflake, each business is different and unique compared to any other business.¹⁶⁵ CEOs and other shareholder executives are different and unique, as are their compensation packages.¹⁶⁶ If a CEO’s compensation is not obviously reasonable or obviously unreasonable, then the Multi-Factor Test fails to provide an objective basis for the court to determine whether the amount paid to the CEO is true compensation or a disguised dividend.¹⁶⁷ The Independent Investor Test, on the other hand, provides an objective test for the court to utilize.¹⁶⁸

Determining whether the hypothetical independent investor would have gotten a high return on his or her investment is much less likely to lead to arbitrary decisions than the Multi-Factor Test.¹⁶⁹ A court can easily research what the average rate of return has been in a publically traded company, or consult the opinions of financial experts.¹⁷⁰ By the same token, the IRS could conduct this same analysis, and publish what it considers to be a reasonable rate of return each year.¹⁷¹

¹⁶⁴ *Exacto Spring*, 196 F.3d at 838.

¹⁶⁵ *But see* Joanne Kennell, *Snowflakes Are Not as Unique as We Thought*, THE SCI. EXPLORER (Dec. 3, 2015), <http://thescienceexplorer.com/nature/snowflakes-are-not-unique-we-thought> (“Now we have been told that all snowflakes are unique — which is true on the molecular level — however, it turns out all snowflakes fall into one of 35 different shapes, according to researchers.”).

¹⁶⁶ *See Menard, Inc. v. Comm’r*, 560 F.3d 620, 623 (7th Cir. 2009).

¹⁶⁷ *See supra* note 141 and accompanying text.

¹⁶⁸ *See Menard*, 560 F.3d at 623.

¹⁶⁹ *See id.*

¹⁷⁰ Although historical average rate of return is a complex question, experts agree that average rate of return is in the ballpark of ten to twelve percent. *See, e.g., What is the Average Annual Return for the S&P 500?*, INVESTOPEDIA (April 24, 2015), <http://www.investopedia.com/ask/answers/042415/what-average-annual-return-sp-500.asp>.

¹⁷¹ In fact, the cases suggest that the IRS provides experts to testify to this rate of return in court anyway. *See, e.g., Exacto Spring Corp. v. Comm’r*, 196 F.3d 833, 838–39 (7th Cir. 1999) (“The [IRS] expert believed that investors in a firm like Exacto would expect a 13 percent return on their investment.”). Thus, if the IRS were to conduct the research, it is unlikely that it would overly burden the agency. *See id.*

Not only would this objective test create consistency between the circuit courts and the individual judges, but the test also allows the taxpayers to plan for the future. Assuming that at least one of the reasons that the IRS focuses on small businesses for disguised dividends is because those businesses have a lack of accountability regarding salary and disguised dividends, then a predictable and objective test could encourage small business owners to give themselves more reasonable salaries.¹⁷²

2. The Independent Investor Test Is Financially and Economically Logical

The appropriate amount of compensation for most shareholder-employees is based on economic factors (e.g., supply and demand, efficiency, profitability, etc.).¹⁷³ Nevertheless, when determining whether a shareholder-employee's compensation is excessive, the courts often fail to consider these economic factors.¹⁷⁴ This results in pressure for all small shareholder-employees to receive a smaller salary, as well as disincentive for small business owners in general.¹⁷⁵

This is not the original intent behind the disguised dividend doctrine.¹⁷⁶ The doctrine is designed to prevent schemes to evade paying taxes, not to tell a shareholder-employee what his or her salary should be.¹⁷⁷ The Independent Investor Test is a rational test that attempts to make the reasonable salary determination based on economic considerations.¹⁷⁸

¹⁷² See *Menard*, 560 F.3d at 622.

¹⁷³ See *id.* at 626 (“A risky compensation structure implies that the executive’s salary is likely to vary substantially from year to year—high when the company has a good year, low when it has a bad one.”).

¹⁷⁴ See *id.* at 627 (criticizing the Tax Court for disregarding important economic factors such as total compensation and differences in responsibilities and performances between multiple CEOs.).

¹⁷⁵ See *supra* note 54 and accompanying text.

¹⁷⁶ See *Appeal of Webb & Bocorselski, Inc. v. Comm’r*, 1 B.T.A. 871, 875 (1925) (“We believe that [the two business owners] were the best judges as to their earning power and the amount the business could pay them. We can not overlook the fact that this was a very close corporation, developed solely through the efforts, privation, and ability of these two men.”).

¹⁷⁷ See *id.*

¹⁷⁸ See *Menard*, 560 F.3d at 622 (explaining that a CEO of a publicly traded company would not take an excessive salary because then the shareholders would suffer).

Additionally, the test applies a more consistent and predictable treatment of different shareholder-employees.¹⁷⁹

C. Disadvantages of the Independent Investor Test

1. The Independent Investor Test Is Unclear and Unspecific

Under the Independent Investor Test, when the independent investor receives a rate of return far higher than the investor had any reason to expect, then the salary is presumed reasonable¹⁸⁰ Much like the factors in the Multi-Factor Test, this rule appears to be logical until you begin to dissect these rules in cases that could go either way.¹⁸¹ How much higher does an amount need to be to qualify as “far higher”? Whose expectations are the court supposed to be using? These questions are unanswered by the case law.¹⁸² Perhaps, like suggested above, the independent investor must receive a rate of return above a specific percentage determined every year by the IRS.¹⁸³ If that is the case, then a CEO’s salary is dependent solely on the general economic conditions as determined by a governmental agency.¹⁸⁴ Thus, the Independent Investor Test is not really as objective as the courts make it out to be.¹⁸⁵

Additionally, not many appellate *courts* have actually applied the Independent Investor Test.¹⁸⁶ As noted above, the Multi-Factor Test is the

¹⁷⁹In summary, the rate of return necessary for a hypothetical independent investor to get a sufficient rate of return would most likely make investors of real companies rather envious of the hypothetical investor. *See, e.g., id.* at 624 (rate of return at about nineteen percent); *Exacto Spring Corp. v. Comm’r*, 196 F.3d 833, 839 (7th Cir. 1999) (rate of return at about twenty percent); *Elliotts, Inc. v. Comm’r*, 716 F.2d 1241, 1248 (9th Cir. 1983) (same).

¹⁸⁰*See Exacto Spring*, 196 F.3d at 839.

¹⁸¹*See supra* note 119 and accompanying text.

¹⁸²Due to the lack of direction, individual judges are most likely to consider himself or herself as the hypothetical independent investor. As discussed above, a relatively modestly paid government official is not likely the ideal investor for a small business paying a large salary to a shareholder-employee. *See supra* note 138.

¹⁸³*See supra* note 171 and accompanying text.

¹⁸⁴*See supra* note 171. Coincidentally, judging reasonableness based off general economic conditions is one of the overly vague factors in the Multi-Factor Test. *See, e.g., Mayson Mfg. Co. v. Comm’r*, 178 F.2d 115, 119 (6th Cir. 1949).

¹⁸⁵*Cf. Menard, Inc. v. Comm’r*, 560 F.3d 620, 623 (7th Cir. 2009) (“In *Exacto*, in an effort to bring a modicum of *objectivity* to the determination of whether a corporate owner/employee’s compensation is ‘reasonable’” (emphasis added)).

¹⁸⁶*See supra* note 71 and accompanying text.

majority approach between the two tests.¹⁸⁷ In fact, only the Seventh Circuit has written an opinion expressly utilizing the Independent Investor Test.¹⁸⁸ Therefore, it is difficult to determine whether the Multi-Factor Test is just as flawed as it is described by the Independent Investor Test cases,¹⁸⁹ or if the Seventh Circuit judges, led by Judge Posner, simply do not like applying multiple factor analyses.¹⁹⁰

Moreover, the rules regarding rebutting the presumption created by the independent investor's adequate rate of return are just as unhelpful as the factors in the Multi-Factor Test.¹⁹¹ For one, the cases are not entirely clear what facts or circumstances justify a rebuttal of the presumption.¹⁹² As explained above, the court provided a few examples of facts that would rebut the presumption.¹⁹³ These circumstances are factors considered in the Multi-Factor Test.¹⁹⁴ Therefore, like the Multi-Factor Test, the Independent Investor Test does not provide adequate guidance to courts to make a rationale decision in close cases.¹⁹⁵

¹⁸⁷ See *supra* note 71 and accompanying text. *But see* *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 838 (7th Cir. 1999) (explaining that many of the other circuit courts already adopted the Independent Investor Test, despite claiming to apply the Multi-Factor Test).

¹⁸⁸ Specifically, Judge Posner has been the only author of any of these opinions. See *Exacto Spring*, 196 F.3d at 834; see also *Mulcahy, Pauritsch, Salvador & Co. v. Comm'r*, 680 F.3d 867, 869 (7th Cir. 2012); see also *Menard, Inc.*, 560 F.3d at 621.

¹⁸⁹ See *supra* note 124 and accompanying text.

¹⁹⁰ Judge Posner has been critical of multi-factor legal tests in other areas of the law as well. See, e.g., *United States v. Moreland*, 703 F.3d 976, 986 (7th Cir. 2012) (Posner, J.) (“Our court and, again, other courts as well have expressed concern with the looseness of multifactor tests in other contexts. They are to be avoided if possible.” (citations omitted)); *Marrs v. Motorola, Inc.*, 577 F.3d 783, 788 (7th Cir. 2009) (Posner, J.) (“That sounds like a balancing test in which unweighted factors mysteriously are weighed. Such a test is not conducive to providing guidance to courts or plan administrators.”); *Palmer v. City of Chi.*, 806 F.2d 1316, 1318 (7th Cir. 1986) (Posner, J.) (“[A]s with so many multi-‘pronged’ legal tests it manages to be at once redundant, incomplete, and unclear.”).

¹⁹¹ See *supra* notes 153–158 and accompanying text.

¹⁹² See, e.g., *Mulcahy*, 680 F.3d at 871 (“When this is a possibility, *other factors* besides the percentage of return on equity have to be considered, in particular comparable salaries.” (emphasis added)).

¹⁹³ See, e.g., *Menard*, 560 F.2d at 623 (including situations such as unexpected discovery of oil, the employee does not work for the corporation, conflicts of interests, or an illogical comparison between the shareholder-employee and other executives); see also *supra* notes 154–158 and accompanying text.

¹⁹⁴ See *Mayson Mfg. Co. v. Comm'r*, 178 F.2d 115, 119 (6th Cir. 1949).

¹⁹⁵ See *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 838 (7th Cir. 1999) (“The [Multi-Factor Test] . . . does not provide adequate guidance to a rational decision.”).

2. The Independent Investor Test Is Inconsistent with the Treasury Regulations and Congressional Intent

The Seventh Circuit adopted the Independent Investor Test to create a simpler and more purposeful test to determine whether an amount is truly compensation or if the amount is actually a disguised dividend.¹⁹⁶ In a proper legal analysis, however, accuracy and correctness should not be sacrificed for simplicity.¹⁹⁷ Perhaps that is why the Tax Court, outside of the Seventh Circuit, has refused to adopt the Independent Investor Test.¹⁹⁸

More importantly, simplicity should not be achieved at the expense of ignoring Congressional or regulatory intent.¹⁹⁹ Section 162 provides that a deduction is allowed for all “ordinary and necessary expenses paid or incurred during the taxable year” including a reasonable allowance for salaries or other compensation.²⁰⁰ Commentators suggest that Congress intended “reasonable allowance” to mean that courts should consider “messy facts and circumstances” when evaluating reasonable compensation.²⁰¹ Thus, a test that attempts to avoid considering “messy facts” is inconsistent with the statute.²⁰²

Additionally, the Treasury Regulations instruct, expressly or implicitly, the court to consider the facts and circumstances to determine the reasonableness of a shareholder-employee’s compensation, or lack thereof.²⁰³ Accordingly, the courts must give deference to these regulations under the *Chevron* Doctrine.²⁰⁴ A test that focuses almost exclusively one factor (i.e., return on equity) is inconsistent with a facts and circumstances

¹⁹⁶ *See id.*

¹⁹⁷ *See* Haffner’s Serv. Stations, Inc. v. Comm’r, 326 F.3d 1, 4 (1st Cir. 2003).

¹⁹⁸ Beth Stetson et. al., *Courts Don’t Follow: Reasonable Compensation Rulings and the Exacto Spring Approach*, 15 CHAP. L. REV. 343, 351 (2011) (noting that the Tax Court did not adopt the Independent Investor Test, despite the taxpayer’s objections).

¹⁹⁹ *See id.* at 360 (“Even if the *Exacto Spring* approach is a ‘better’ or even the ‘best’ approach to determining reasonable compensation, it is legally improper for the Seventh Circuit to substitute such approach for that of Regulation 1.162-7.”).

²⁰⁰ I.R.C. § 162(a) (2012 & Supp. II 2014).

²⁰¹ *See, e.g.*, Stetson, *supra* note 198, at 357–58 (noting that Congress has established “bright line test” for other areas of tax law, thus Congress could have done the same for “reasonable allowance” if that was its true intent).

²⁰² *See id.*; *see also* I.R.C. § 162.

²⁰³ Treas. Reg. §§ 1.162-7(b), 1.162-8 (2016).

²⁰⁴ *See* *Chevron, U.S.A., Inc., v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984); *see also supra* note 66.

test.²⁰⁵ Therefore, some commentators have concluded that applying the Independent Investor Test is improperly ignoring the Treasury Regulations.²⁰⁶ Interestingly, the Seventh Circuit never addresses these regulations in its cases.²⁰⁷

V. RECOMMENDATION AND CONCLUSION

A. *The Independent Investor Test and the Multi-Factor Test Should Be Combined into a Single Two-Pronged Test*

This comment has illustrated just how unpleasant it is living in the lobster pot that is taxation of C Corps.²⁰⁸ It should be of no surprise that avoiding double taxation has been a primary concern of business owners for years.²⁰⁹ In fact, avoiding double tax was the primary motivation for the creation of the limited liability company (“LLC”).²¹⁰ Since the Department of Treasury issued the check-the-box-regulations²¹¹, multi-member LLCs are taxed as a partnership by default, which avoids the dreaded double tax.²¹² Alternatively, small business owners may have the option of being taxed as a corporation under Subchapter S of the IRC (S Corp).²¹³ Thus, the number of new businesses forming as C Corps. has decreased dramatically over the past few decades.²¹⁴ Not to mention, the future of the IRC is uncertain, to say the least.²¹⁵

²⁰⁵ See Stetson, *supra* note 198, at 361.

²⁰⁶ See *id.* at 360 (“Even if the [Independent Investor Test] is a ‘better’ or even the ‘best’ approach to determining reasonable compensation, it is legally improper for the Seventh Circuit to substitute such approach for that of Regulation 1.162-7.”).

²⁰⁷ See *Mulcachy, Pauritsch, Salvador & Co. v. Comm’r*, 680 F.3d 867 (7th Cir. 2012); *Menard, Inc. v. Comm’r*, 560 F.3d 620 (7th Cir. 2009); see generally *Exacto Spring, Corp. v. Comm’r*, 196 F.3d 833 (7th Cir. 1999).

²⁰⁸ See *Peracchi v. Comm’r*, 143 F.3d 487, 489 n.2 (9th Cir. 1998).

²⁰⁹ See, e.g., George Mundstock, *Taxation of Intercorporate Dividends Under an Unintegrated Regime*, 44 TAX L. REV. 1, 24 (1988) (“[T]he double tax affects the decision whether to use the corporate form at all.”).

²¹⁰ See 2-33 BUSINESS ORGANIZATIONS WITH TAX PLANNING § 33.07 (2017) (“A limited liability company may be treated as either a partnership or a sole proprietorship for federal income tax purposes, thereby avoiding corporate two-tier taxation.”).

²¹¹ See Treas. Reg. §§ 301.7701-1 to -3 (2016).

²¹² See *id.* § 301.7701-3(b).

²¹³ See I.R.C. §§ 1361–62 (2012 & Supp. II 2014).

²¹⁴ William McBride, *America’s Shrinking Corporate Sector*, TAX FOUNDATION (Jan. 6, 2015), <http://taxfoundation.org/article/america-s-shrinking-corporate-sector> (“The number of

Assuming that the federal government) will be seeking more tax revenue in the coming years, the proper way to determine what is a reasonable compensation for shareholder-employees continues to be an important issue—albeit, decreasing in importance over time.²¹⁶ Also, it is worth noting that other areas of law require a fact determination as to whether a business owner's salary is reasonable.²¹⁷ Thus, a uniform analysis would benefit these areas of law as well as benefit taxation of C Corps.

The Multi-Factor Test and the Independent Investor Test should not be mutually exclusive tests. The Independent Investor Test provides a simple formula to create a presumption of reasonableness or a presumption of true compensation. This presumption can foster judicial efficiency because simpler cases can be decided without time and resources. Additionally, the presumption can serve as a safe harbor for both the IRS and for the taxpayer. Therefore, less money will be spent investigating and trying these disguised dividend cases, which will also assist in decreasing the federal budget deficit issue. To quote Judge Posner, "So far, so good."²¹⁸

Additionally, the Independent Investor Test is not necessarily the end of the analysis. As discussed above, certain factors from the Multi-Factor Test

traditional C corporations in the U.S. has fallen to a historically low level There is now more net business income taxed under the individual income tax system than the traditional corporate tax code, a trend that does not appear to be stopping any time soon.").

²¹⁵ See Naomi Jagoda, *Chairman: Trump Can Play 'Key Role' in Tax Reform Push*, THE HILL (Dec. 7, 2016), <http://origin-ny1.thehill.com/business-a-lobbying/business-a-lobbying/309118-chairman-trump-can-play-key-role-in-tax-reform-push> (noting that both Donald Trump and the republicans in Congress released a tax reform plan in 2016).

²¹⁶ McBride, *supra* note 214 (reporting that IRS data in 2011 indicated 1.6 million C Corps. still exist).

²¹⁷ See, e.g., *Jensen v. Jensen*, 665 S.W.2d 107, 110 (Tex. 1984) (explaining that one spouse will have a community claim for reimbursement for the other spouse's time and effort to the other's business if the other spouse was not reasonably and adequately compensated). Perhaps the most analogous area of law is regarding the treatment of Subchapter S Corporations (S Corps.). Courts will re-characterize dividend distributions as wages (which are subject to payroll taxes) when the shareholder-employee has received an unreasonably small salary. See, e.g., *Spicer Acc't v. United States*, 918 F.2d 90, 93 (9th Cir. 1990) ("[The shareholder-employee] clearly performed substantial services . . . accordingly, these 'dividends' were in reality remuneration for employment and therefore subject to [payroll taxes]."); see also Rev. Rul. 74-44, 1974-1 C.B. 287 (explaining that a S Corp. cannot arrange to receive dividends rather than compensation so that the S. Corp. may avoid paying employment taxes).

²¹⁸ *Boyd v. Wexler*, 275 F.3d 642, 644 (7th Cir. 2001).

can rebut the presumption.²¹⁹ If the presumption is rebutted, then the burden of proof returns to the taxpayer to show that the salary is reasonable.²²⁰ Combining the approaches provides a more objective test, but still allows the facts and circumstances to be considered. In other words, the courts should apply the Independent Investor Test as an initial prong to establish a rebuttable presumption. If that prong is not satisfied, then the courts should apply the Multi-Factor Test as a second prong. Such an analysis utilizes the best of both worlds.

The courts should, however, modify the tests to eliminate some of the confusion and to add additional clarity. For example, under the Independent Investor prong of the test, the rate of return should have a more objective standard than the “far higher” standard used now. The cases applying the Independent Investor Test included C Corps where a hypothetical independent investor would have received a rate of return around twenty percent.²²¹ That percent is practically unattainable in the open market.²²² Thus, based on the current state of the United States economy, twenty percent should be the minimum rate of return to trigger the presumption under the Independent Investor prong.

Additionally, the Multi-Factor Test needs to have fewer factors and less vague factors. Although, all facts and circumstances are relevant to the Treasury Regulation, the enumerated factors should be more concise and to the point. Clearly, over twenty factors are too many for the Multi-Factor Test.²²³ Revisions to the factors should make the factors less arbitrary, and more consistent with the treatment of publicly traded corporations.²²⁴

B. Conclusion

When the IRS believes that a shareholder-employee’s compensation from a C Corp is a disguised dividend, then the shareholder-employee must

²¹⁹ See, e.g., *Menard, Inc. v. Comm’r*, 560 F.3d 620, 623 (7th Cir. 2009) (including situations such as “unexpected discovery of oil,” the employee does not work for the corporation, conflicts of interests, or an illogical comparison between the shareholder-employee and other executives).

²²⁰ See *id.*

²²¹ See, e.g., *Menard*, 560 F.3d at 624 (rate of return at about nineteen percent); *Exacto Spring Corp. v. Comm’r*, 196 F.3d 833, 839 (7th Cir. 1999) (rate of return of about twenty percent); *Elliotts, Inc. v. Comm’r*, 716 F.2d 1241, 1248 (9th Cir. 1983) (same).

²²² See *supra* note 170.

²²³ See *Exacto Spring*, 196 F.3d at 834 (noting that twenty-one factors is “astonishing.”).

²²⁴ See *supra* Part III.C.

turn to the courts to avoid the IRS's reallocation.²²⁵ Currently, the shareholder-employee litigating such a controversy in one jurisdiction may receive a completely different result than an identical shareholder-employee in another jurisdiction.²²⁶ Taking the advantages of both the Multi-Factor Test and the Independent Investor Test by combining these tests, however, can easily solve the current circuit court split. Such a combination would not only provide consistency, but it would also provide more efficiency and clarity regarding disguised dividends. Therefore, living in the C Corp lobster pot may be slightly less complex, painful, and difficult to live in.²²⁷

²²⁵ See, e.g., *Appeal of Webb & Bocorselski, Inc. v. Comm'r*, 1 B.T.A. 871, 876 (1925) (reversing the Commissioner's disallowance of a corporate owner's deduction of shareholder-employees' salaries after finding the amounts were reasonable compensation.).

²²⁶ See *Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971) ("[I]t is our best judgment that better judicial administration requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone."); see also *supra* note 95 and accompanying text.

²²⁷ See *Peracchi v. Comm'r*, 143 F.3d 487, 489 n.2 (9th Cir. 1998).