

Chapter 4

Employee Compensation

Solutions to Develop Research Skills

Note to Instructor: No research aids or “hints” are provided in the textbook for problems in this chapter. Before the solution to each problem, however, suggested research aids are provided. This allows you to choose whether or not to provide any hints to your students for a particular problem. For problems that can be solved using free Internet sources, you must provide students with the citations in these hints and refer students to Figure 2.2 of Chapter 2 in the text for the URLs to enable them to solve these problems using free Internet sources. Some of the problems require access to *Checkpoint®* or a similar service. The research process for solving a sample problem is illustrated in Appendix A through screen captures for *RIA Checkpoint®*.

56. *Reasonable Compensation and Timing Issues (can be solved using Checkpoint® or a similar service)*

Martin Martindale, the 40-year-old founder and President of Martindale Corporation (an accrual-basis calendar-year C corporation), owns 60 percent of the stock and receives a salary of \$600,000. Four unrelated shareholders own the rest of the stock equally. The corporation has paid dividends regularly to the shareholders and plans to continue to do so in the future. Martin plans to recommend that the board of directors authorize the payment of a bonus to himself and two other employees (all cash-basis calendar year individuals). The first employee is the vice president, who owns 10 percent of the corporation and receives a salary of \$400,000. The other employee is the controller, who is not currently a shareholder in the corporation and receives a salary of \$200,000. Martin would like the bonus to equal 75 percent of each recipient's current salary. Martin believes that the annual salaries are probably a little high when compared to the corporation's competitors. Martin asks you, as the corporation's tax advisor, to recommend what the corporation needs to do so that it gets a deduction for the planned bonuses. Martin would prefer that the bonuses be paid next year but deducted by the business this year.

- a. Locate and read *Mayson Manufacturing Co.*, 178 F.2d 115, 38 AFTR 1028, 49-2 USTC ¶9467 and then summarize the important points of this case as it relates to Martindale.
- b. Prepare a summary of the relevant Code and regulation sections as they apply to Martindale.
- c. Prepare a one-paragraph summary for Martin on what the corporation needs to do to qualify for a deduction for the planned bonuses.

a. In the case of *Mayson Manufacturing*, the IRS disallowed a portion of the compensation paid to three officers as being unreasonable in amount. The facts state that the Petitioner felt that the company would prosper more if a bonus system was established for *Mayson Manufacturing Co.* In this case, the board agreed to bonuses based on a percentage of the net profits and a percentage of gross sales. The Tax Court ruled in favor of the IRS. The Tax Court's ruling was based in part upon its finding that the compensation, including the basic salary and bonus, paid to *Mayson's* officers did not result from an arm's length transaction. The Appellate Court stated that each case of this kind must be based on the individual company's facts and circumstances. Some of the factors to be considered include:

- ◆ The employee's qualifications
- ◆ The nature, extent and scope of the employee's work
- ◆ The size and complexities of the business
- ◆ A comparison of salaries paid with the gross and net income of the business
- ◆ The prevailing general economic conditions
- ◆ A comparison of salaries with distributions to stockholders

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- ◆ The prevailing rates of compensation for comparable positions
- ◆ The amount of compensation paid to the employee in previous years
- ◆ The salary policy of the corporation

The Appellate Court found that the basic salary and bonus plan was, in fact, made in good faith. Furthermore, no evidence was introduced by either party in regard to what compensation other companies engaged in the same type of work paid for comparable services during the year in question. Such evidence, if available would have a bearing upon the issue. The Appellate Court held that the facts in Mayson suggested the amounts paid as compensation were reasonable.

b. Sec. 162(a)(1) allows a reasonable deduction for salaries or other compensation.

Sec. 267 states that a deduction is not allowed for compensation accrued to a "related party" until the payment is made. This section defines a "related" taxpayer to include a shareholder owning more than 50% of the corporation (Martin).

Reg. Sec. 1.404(a)-1(b) states that in determining what is considered reasonable compensation, personal services actually rendered in prior years as well as the current year and all compensation paid to the employee should be considered.

Reg. Sec. 1.404(b)-1T(b)(1) states that payment made after the fifteenth day of the third calendar month after the employer's taxable year in which the services are rendered will be considered deferred compensation. This means it will not be deductible until the year paid and included in the income of the employee.

c. a. In order to qualify for a deduction for the planned bonuses, the bonus plan must be considered reasonable. The factors to consider as to reasonableness are those listed in the Mayson Manufacturing case. The corporation will need to be able to justify the reasoning for salaries that exceed the norm in the industry. Rather than base the bonus plan on a percentage of the employee's salaries, it might be better to pay a bonus based on the percentage of income or sales of the company. In addition, Martindale Corporation must pay the bonus to Martin before December 31 if it wants to deduct his bonus in the current year. For the other two employees, the liability for their bonuses must be determined by December 31 and then paid by March 15th next year if it wants to deduct these bonuses in the current year.

57. *Income from Personal Use of Corporate Aircraft (can be solved using free Internet sources)*

McGuire Corporation is planning to acquire a corporate jet to increase the efficiency and security of its executives who will use the jet for both business trips and personal vacations. McGuire Corporation wants to know how it should determine the amount that is taxed to its employees when they use the corporate jet for personal travel.

Hint: Regulation Section 1.61-21(b) and (g); Revenue Ruling 2013-8, 2013-15 IRB 763.

When corporations allow employees to use corporate aircraft for nonbusiness trips, there are several methods that can be used to value the personal use of employer-provided noncommercial aircraft. If the employee's flight is primarily personal, under Reg. Sec. 1.61-21(b), the value of the flight is the amount that an individual would have to pay in an arm's-length transaction to charter the same or a comparable piloted aircraft. The flight's charter cost must be allocated among all employees on board, unless one or more of the employees controlled the use of the aircraft. Control is defined as the ability of the employee to determine the route, departure time, and destination of the flights. When one or more employees control the use of the aircraft, the value of the flight is allocated among them only, unless a written agreement among all employees on the flight determines otherwise.

There are two other more favorable special valuation methods: (1) the seating capacity method

and (2) the Standard Industry Fare Level (SIFL) formula. The seating capacity method, if applicable, will produce the best result from a tax viewpoint, because the employee may have no taxable income at all under that rule. The seating capacity method can be used if 50 percent or more of the regular passenger seating capacity of an aircraft is occupied by persons who are traveling primarily for the employer's business. If the 50 percent seat occupancy is met, the value of the flight for any employee who is traveling primarily for nonbusiness purposes is treated as zero. Under this rule, only employees are considered. As a result, independent contractors and directors of the employer are not counted toward the 50 percent of seats occupied for the employer's business.

To determine if this valuation rule is available, the 50 percent seating capacity requirement must be met when the individual whose flight is being valued both boards and deplanes the aircraft. The aircraft seating capacity is the maximum number of seats installed on the aircraft at any time prior to the date of the flight (when owned or leased by the employer), even if some seats have been removed for the flight in question. It does not, however, include seats that are not legally usable during takeoff (such as jump seats). If the employer permanently removes seats from the aircraft, the regular seating capacity will be deemed reduced, provided that such seats are not added within the following 24 months.

If the seating capacity method does not apply, then the value of the flight may be calculated using the SIFL formula. This method takes four factors into account: (1) miles flown, (2) aircraft size (weight), (3) passenger status (whether the passenger is a control employee), and (4) a terminal charge.

Control employees are defined in Regulation Section 1.61-21(g)(8) as:

- Employees who are officers of the employer (the lesser of 10 employees or 1 percent of all employees),
- Employees who are among the top 1 percent most highly compensated employees (up to 50 employees),
- Employees who own 5 percent or greater equity, capital, or profits interest in the employer, or
- Directors of the employer.

Under this method, a three-step calculation is used to determine the personal-use compensation:

1. On a per-individual basis, the number of miles flown is multiplied by the SIFL cents-per-mile charge in effect for the period during which the flight is taken.
2. This figure is then multiplied by the appropriate aircraft multiple, based on use by a control or noncontrol employee.
3. A terminal charge is added.

The SIFL cents-per-mile amount and the terminal charge are calculated by the Department of Transportation and revised semiannually. Revenue Ruling 2013-8 specifies the amounts to be used for this computation for the first 6 months of 2013.

When a flight is taken for both personal and business reasons, the valuation is dependent on whether the flight was primarily for business purposes or primarily for personal purposes. If the trip is primarily for the employer's business, the employee includes in income only the excess of the value of all the flights over the value of the flights that would have been taken if there were no personal flights. If the trip is primarily personal, the full value of all flights is includible in the employee's income.

Income may also be imputed when a family member accompanies an employee. A family member of a control employee will be deemed a control employee for purposes of the

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valuation. A family member is any party covered by Section 267(c)(4), including brothers, sisters, spouses, ancestors, and lineal descendants. This also means that if the value of the flight to the employee is zero based on the seating capacity method, the value is also zero for a spouse or child.

This problem can easily be extended to ask about restrictions on the employer's deduction. The American Jobs Creation Act of 2004 amended Section 274(e) partially overturning the holding in *Sutherland Lumber* (88 AFTR 2d 2001-5026) by limiting the corporate deduction to the amount taxed to certain individuals (such as officers, directors, and greater-than-10-percent owners) as compensation for their personal flights. IRS provides detailed guidance on this in Regulation Section 1.274-10.

58. *Premature Withdrawal from IRA (can be solved using free Internet sources)*

Robert, age 35, has accumulated \$36,000 in his traditional IRA. He recently married and would like to withdraw \$25,000 from his IRA for a down payment on their first house. Write a letter to Robert stating the tax implications of his proposed withdrawal.

Hint: Section 72(t)(2)(F)

Dear Robert:

In our last meeting, we discussed your desire to withdraw \$25,000 from your IRA account to purchase your first home. Under Internal Revenue Code Section 72(t)(2)(F), individuals under 59½ can avoid the 10 percent early withdrawal penalty if the withdrawal is for a first home purchase. However, the regular income tax on the distribution will still apply.

Section 72(t)(8) provides a lifetime limit of \$10,000 on the amount of withdrawals that can be taken out without a penalty under the first-time homebuyer provision. If you withdraw \$25,000 from your IRA, you will be subject to the 10 percent early withdrawal penalty on the excess \$15,000. The penalty amount would be \$1,500 (\$15,000 x 10%). In addition, you will be required to pay income tax on the entire \$25,000 withdrawal.

You have an alternative method to reduce the withdrawal penalty if your wife has sufficient funds in her IRA. If she does, she may also be able to withdraw up to \$10,000 without incurring the 10 percent penalty. This alternative would reduce your penalty to \$500, which is based on an excess \$5,000 withdrawal.

If you have any questions or would like to discuss this matter further, please do not hesitate to call. I look forward to hearing from you.

59. *Premature Withdrawal from IRA (can be solved using free Internet sources)*

Jennifer, age 40, has accumulated \$40,000 in her traditional IRA. She would like to withdraw \$22,000 from her IRA to pay for her daughter's college expenses. She plans to use \$15,000 for tuition and \$7,000 for room and board. Write a letter to Jennifer stating the tax implications of her proposed withdrawal.

Hint: Section 72(t)(2)(E)

Dear Jennifer:

In our last meeting, we discussed your desire to withdraw \$22,000 from your IRA account to pay for your daughter's college expenses. Under Internal Revenue Code Section 72(t)(2)(E), individuals under 59½ can avoid the 10 percent early withdrawal penalty if the withdrawal does not exceed the qualified higher education expenses. These expenses must be incurred by yourself, your spouse or your child to be eligible for exclusion from the early withdrawal penalty. However, the regular income tax on the distribution will still apply.

Section 529(e)(3) of the Internal Revenue Code defines qualified higher education expenses to include tuition, fees, books, supplies and equipment. The amount treated as qualified higher education expenses for room and board is limited to the allowance included in the cost of attendance as determined by the eligible educational institution that your daughter attends. If the \$7,000 exceeds the allowance amount, the actual invoice amount for room and board will be used providing the housing is owned or operated by the eligible educational institution. Thus, the \$22,000 should be fully excludable from the early withdrawal penalty. However, the full distribution amount will be taxed at your ordinary income tax rate.

If you have any questions or would like to discuss this matter further, please do not hesitate to call. I look forward to hearing from you.