

Veterinary Surgical Consultants, P.C. meets Pediatric Surgical Associates, P.C.: Now What Do I Do With My Professional Corporation?

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If a professional corporation is a C corporation, the shareholders will typically be better off if the corporation is paying high salaries and low dividends because salaries are deductible while dividends are not. In an S corporation, the shareholder will typically be better off by paying higher dividends than salaries because salary is subject to self employment taxes while a dividend distribution is not. (The dividend distribution is subject to only one layer of income tax in the S context).

In *Veterinary Surgical Consultants, P.C.*, the Tax Court held that the sole professional shareholder of an S corporation was subject to self employment tax on what the shareholder had claimed were distributions of net corporate income. The corporation's only source of income was from veterinary consulting services of the sole shareholder. It is worthy of note that the shareholder was employed full-time and received wages reported on a W-2 from Bristol-Myers.

In *Pediatric Surgical Associates, P.C.*, the Tax Court disallowed "bonuses" to surgeon-shareholders as unreasonable compensation and treated the payments as dividends. The Tax Court treated the amounts attributable to profits from non-shareholder surgeons as the amount subject to dividend treatment. (A significant concern not mentioned in this case would be the impact on corporate retirement plans if a compensation deduction were disallowed so that the amount allowed as compensation were less than the amount allowed as Covered Compensation for purposes of making retirement plan contributions.)

The issue in the professional corporation context, whether C or S, relates to what is going to be treated as "profits" versus "compensation". One response to the results of such cases as *Veterinary Surgical* and *Pediatric Surgical* might be to suggest that all professional corporations should be S corporations and should treat as dividends only those amounts attributable to profits from other than shareholder services. Although this may be the appropriate treatment in some cases, the facts of each professional corporation should be considered. If factors (such as desire to maximize Compensation for purposes of retirement plan contributions) indicate that a C corporation should be retained, then the the Corporation's affairs should simply be structured with due attention to those matters that will protect the corporation's compensation deduction.

To protect the compensation deduction in the C corporation context, do the following:

1. Pay dividends. Dividends can be small but pay them.
2. Pay shareholder bonuses no more frequently than quarterly. The court noted that *Pediatric Surgical* was paying bonuses monthly based on available cash. That approach sets up the IRS classification of such payments as dividends (paying out profits).
3. The corporation should have employment agreements with its shareholders. In addition to setting out the obligations between the shareholder and the corporation, the agreement should be structured to consider the potentiality of unreasonable compensation issues. (They never go away in the professional corporation world.) The agreement should provide that the shareholder may also have duties of an officer or administrator of the corporation (which sets up an argument for compensation in excess of net collections). Avoid statements about a shareholder's services such as "exclusively and actively in the practice of medicine and devoting full time efforts to rendering professional services." Allow for activities (and compensation for) benefiting the corporation that are not rendering professional services.

4. Document salary decisions and bonus payments in the corporate minutes. Note special efforts of the employee, services as an officer, extraordinary efforts by the shareholder, mentoring efforts, high productivity, and effectiveness. Consider actually having at least one board meeting per year to set salaries, pay year end bonuses, pay dividends and discuss administrative roles of the shareholders.
5. Consider allocating (in the minutes) a salary payment as payment for prior years in which the shareholder-employee was under-compensated. This works well in a situation where there were lean years when a business was getting off the ground.
6. Have the shareholders enter into a salary repayment agreement in which the shareholders agree to repay the corporation any amounts determined by the Internal Revenue Service to be unreasonable compensation.

To protect the dividend treatment of payments in the S corporation context, do the following:

1. Pay some salary, especially if there is only one shareholder and the income is from such shareholder's services. Make the salary regular and consistent. An easy audit flag is an S corporation with no salary payments at all. (There were no salary payments in *Veterinary Surgical*.)
2. Document salary payments in the corporate minutes. Document S dividends in the corporate minutes. To the extent profits can be credited to sources other than the shareholder's services, note that in the minutes. Be diligent about documentation without overdoing it. (Doing so will help with liability issues as well.)
3. Don't use the corporate checking account to pay personal bills and then treat such payments as dividends. If personal expenses are paid from the corporation, reimburse the corporation.
4. Make occasional "dividend" payments. In *Veterinary Surgical*, the court noted that shareholder withdrew money from the corporate bank account at his discretion.
5. Consider carefully the treatment of all sources of income of the shareholder. Coordinate.

The Internal Revenue Service will continue to seek ways to treat S corporation dividends as compensation and C corporation compensation as dividends. Neither approach is new. Regardless of the form of corporation, the answer is not to make wholesale changes to corporate structure but to be reasonable in approach and structure payments with the idea of protecting from IRS attacks.