Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Jenny D. Boissonneault
(LBI)

from: David Silber
(CC:ITA:2)

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

Issue: What is the proper treatment of income adjustments on the Forms 1120 filed by for the taxable years through ("years at issue") as well as for taxable years ?

Facts: is a holding company. Subsidiary develops . is CEO and President of and 100% shareholder. compensation for each year at issue was approximately $. This case would be appealable to the United States Court of Appeals for the Second Circuit (Second Circuit) if filed in the Tax Court or the applicable district court.

During the years at issue made payments to it characterized on its Forms 1120 as deductible business expenses under section 162 that did not include in her gross income. also made separate payments to it characterized as personal (originating from a stipend and direct payments) that reported on her Forms 1040 as additional "Other Income," Line 21. deducted these payments on its Forms 1120 as Meals & Entertainment for the years at issue.

During the audit for the years at issue, the exam team determined that a portion of the claimed business expenses were the personal expenses of , solely benefitting . The exam team intended to disallow these amounts as business deductions to , include them in gross income as additional income, and assert the civil fraud penalty on both .

The year was subsequently included in the audit. The exam team noticed that Stipend and others claimed business expenses that had been deducted by for the years at issue were not deducted by in . Instead, these expenses were recharacterized as personal and a Schedule M adjustment was made on tax return. included them on the Form 1040 as additional "Other Income." In , it appears that treated these "personal expenses" as dividends to .

On , the exam team's manager entered into a verbal settlement, whereby agreed to an adjustment equaling % of the adjustments for the years at issue, a penalty under section 6662 to be applied to the deficiency resulting from those adjustments, and a "no change" to the taxable year. The Internal Revenue Service (Service) prepared the Forms 4549 for the settlement, and for consistency purposes, included the additional amounts as "Other Income" for .

Taxpayers' position: The payments made by to are includable in her gross income unless otherwise excludable by another section of the Internal Revenue Code (Code). Section 61(a)(1) includes "[c]ompensation for services, including fees, commission, fringe benefits, and similar items" in income. Section 1.61(a) provides that "gross income means all income from whatever source derived, unless excluded by law." *See also DeFabo v. Commissioner,* 4 T.C. Memo 1975-282 (1975), holding that stipends paid to a doctor were includable as gross income under section 61(a)(1).

Consistent with the treatment of the payments as income to , is entitled to a deduction for the amount paid under 162(a)(1), unless otherwise limited by another section of the Code. *See also* section 1.162-7(a). The only section of the Code that limits the deductibility of compensation is irrelevant to this case, as it only applies to publicly held corporations. See section 162(m). Thus, the "Other Income" adjustment must be treated as compensation paid to the employee ( ) and deductible by the employer ( )…had the IRS characterized the adjustment differently (e.g., as a dividend or wages), the adjustment would have to be treated consistent with that characterization on the returns. In the case of a dividend, would not deduct the amount distributed and, in this case, would be eligible for qualified dividend treatment, reportable on Line 3a of her Form 1040.

LBI's Discussion/Analysis: is not arguing that the additional amounts were additional forms of compensation paid to for efforts in running the company. is claiming that because the amounts were included as additional "Other Income" the amounts must be characterized as compensation. It is clear that the amounts paid were for the personal expenses of and there was no documentation submitted to substantiate any business purpose/nexus for the payments. Further, was clearly well compensated for the years at issue; there is no argument that was undercompensated for services. The amounts are not compensation. The deductibility of the payments depends on their characterization under section 162(a). The amounts paid were not ordinary and necessary expenses

paid during the years at issue to carry on the business of . Whether characterized as additional “Other Income” or not, the expenses are not deductible to . This is also consistent with treatment for the years at issue and . The amounts should be treated as ordinary income to with no corresponding deduction to .

Law and Analysis: Section 162 provides that 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.

Section 1.162-7(a) provides that 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. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

Section 1.162-7(b)(1) provides that any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. 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. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

Section 1.162-7(b)(2) provides that the form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

Section 1.162-7(b)(3) provides that 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. The circumstances to be taken into consideration are those existing at the date when the

contract for services was made, not those existing at the date when the contract is questioned.

Section 1.162-8 provides that 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 payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. If such payments constitute payment for property, they should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price. In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in gross income of the recipient.

Section 1.162-9 provides that bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or which are in excess of reasonable compensation for services, are not deductible from gross income.

First issue: We realize you have asked only about the taxability of the "Other Income," however, all payments made to from should be evaluated to determine deductibility by under section 162. Whether a payment made to by is deductible compensation is a question of fact. Only compensation that is reasonable and paid for personal services actually rendered to is deductible by under section 162. How the parties label or report the payment to the Service does not affect the deductibility of the payment. As a result, in this case it is not material that reported some payments as deductible compensation and others as "Other Income."

There are approximately 400+ opinions (published and unpublished) addressing what is a reasonable allowance for salaries or other compensation for personal services actually rendered for purposes of the deduction under section 162. Because this case is appealable to the Second Circuit if filed in district court or the Tax Court, we have included mostly cases in the Second Circuit and the Tax Court.

In *Botany Worsted Mills v. U.S.*, 278 U.S. 282 (1929), the United States Supreme Court denied a deduction for claimed compensation under a predecessor to section 162 because the compensation was not reasonable. The Court stated on pp 292-293:

> We do not find it necessary to determine here whether the amounts paid by a corporation to its officers as compensation for their services cannot

> be allowed as 'ordinary and necessary expenses' within the meaning of section 12(a), merely because, and to the extent that, as compensation, they are unreasonable in amount. However this may be, it is clear that extraordinary, unusual and extravagant amounts paid by a corporation to its officers in the guise and form of compensation for their services, but having no substantial relation to the measure of their services and being utterly disproportioned to their value, are not in reality payment for services, and cannot be regarded as 'ordinary and necessary expenses' within the meaning of the section; and that such amounts do not become part of the 'ordinary and necessary expenses' merely because the payments are made in accordance with an agreement between the corporation and its officers. Even if binding upon the parties, such an agreement does not change the character of the purported compensation or constitute it, as against the Government, an ordinary and necessary expense. Compare 20 Treas. Dec., Int. Rev., 330; *Jacobs & Davies v. Anderson (*C. C. A.) 228 F. 505, 506; *United States v. Philadelphia Knitting Mills Co*. (C. C. A.) 273 F. 657, 658; and *Becker Bros. v. United States* (C. C. A.) 7 F. (2d) 3, 6.
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> In the light of this principle it is clear that the findings do not show, as a matter of necessary inference resulting as a conclusion of law, that the amount paid the directors in excess of the $782,083.33 allowed by the Commissioner, constituted part of the ordinary and necessary expenses of the Mills. On the contrary, as this amount so greatly exceeded the amounts which, as a matter of common knowledge, are usually paid to directors for their attendance at meetings of the board and the discharge of their customary duties, and was much greater than the amounts that had been paid in prior years, and as there is no showing as to the amounts paid the individual directors, in addition to the salaries of $9,000 which each received-presumably for his services as an executive officer or department manager-or as to the nature, extent or value of their services, the findings raise a strong inference that the unusual and extraordinary amount paid to the directors was not in fact compensation for their services, but merely a distribution of a fixed percentage of the net profits that had no relation to the services rendered.

In *Rapco, Inc. v. Commissioner*, 85 F.3d 950 (2nd Cir. 1996), the Second Circuit affirmed the Tax Court's determinations (*Rapco, Inc. v. Commissioner*, 69 T.C.M. 2238 (1995)) that income tax was owned by the corporation as a result of the deduction of an unreasonable amount of compensation paid to its president. The Second Circuit provided at pp 954-955 that the factors to be considered are as follows:

> What factors are to be considered in making a reasonableness determination is a question of law, which we review de novo; but, the ultimate determination, based on those factors, that the compensation paid was "reasonable" is, at most, a mixed question of law and fact, which

we review only for clear error. *Cf. Bausch & Lomb Inc. v. Commissioner*, 933 F.2d 1084, 1088 (2d Cir.1991); *see also Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1323–24 (5th Cir.1987) *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1323–24 (5th Cir.1987) (reasonableness of compensation is a question of fact); *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1245 (9th Cir.1983) (same). The taxpayer has the burden of proving that the IRS's determination of reasonable compensation is incorrect. *See* Tax Court Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115, 54 S. Ct. 8, 9, 78 L.Ed. 212 (1933). The taxpayer's burden of showing that it is entitled to a larger deduction for compensation than allowed by the IRS is particularly heavy when that compensation is paid to a shareholder-officer. *See Pepsi–Cola Bottling Co. v. Commissioner*, 528 F.2d 176, 179 (10th Cir.1975).

This Court has had no occasion to enunciate comprehensively the factors to be considered in evaluating the reasonableness of employee compensation under 26 U.S.C. § 162(a)(1). The Ninth Circuit, however, in *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir.1983), exhaustively catalogued and analyzed the relevant considerations. *See also Owensby & Kritikos*, 819 F.2d at 1322–25 (discussing some factors). In *Elliotts*, the Ninth Circuit isolated five broad categories: (1) Employee's role in the company: including the employee's position, hours worked, and duties performed, plus any special duties or role (such as personally guaranteeing corporate loans); (2) External comparison with other companies: salaries paid to comparable employees in similar companies; (3) Character and condition of the company: including the sales, net income, capital value, and general economic fitness of the company; (4) Potential conflicts of interest: ability to "disguise" dividends as salary, particularly when the employee is the sole or majority shareholder, and/or where a large percentage of the compensation is paid as a "bonus"; and, (5) Internal consistency in compensation: consistency of the compensation system throughout the ranks of the company. *Elliotts*, 716 F.2d at 1245–48.

No one factor is dispositive. *See id.* at 1245; *Owensby & Kritikos*, 819 F.2d at 1323. Furthermore, the court should assess the entire tableau from the perspective of an independent investor—that is, given the dividends and return on equity enjoyed by a disinterested stockholder, would that stockholder approve the compensation paid to the employee? *See Elliotts*, 716 F.2d at 1245.

We find that the *Elliotts'* factors, examined from the perspective of an independent investor, are an appropriate standard to evaluate the reasonableness of employee compensation. These factors adequately balance the company's financial fitness and role in the market, and the employee's responsibility for that role. They also require a suitable

> comparison of the employee's compensation to other employees in the same company, and similar employees in analogous companies—sturdy benchmarks for determining the reasonableness of an employee's reward. And, these considerations properly patrol a company's ability to substitute salary for dividends by recognizing, in the first place, a shareholder-officer's temptation to do so, and, then, by focusing on the disinterested investor's perspective.

In *Dexsil Corp. v. Commissioner*, 147 F.3d 96 (2nd Cir. 1998), the Second Circuit determined that the Tax Court's failure to assess the reasonableness of compensation paid to Lynn, president of Dexsil, from the perspective of a hypothetical or independent investor was erroneous as a matter of law. Accordingly, it vacated and remanded the Tax Court's opinion for reconsideration. The Second Circuit directed the Tax Court to make specific findings regarding the following questions: (1) whether a hypothetical investor would accept the compensation paid to Lynn; (2) whether Lynn was paid according to a long-standing and consistently applied contingent compensation formula, and if so, whether his salary was reasonable in light of this formula; (3) whether Lynn's compensation compared favorably with the compensation paid by similar companies for comparable services, given the many roles Lynn played at Dexsil; and (4) whether, after reconsideration of these factors, the balance of factors has shifted in favor of Dexsil such that it has met its burden of proving that Lynn's compensation was reasonable.

In *Appeal of Gustafson Mfg. Co.*, 1 B.T.A. 508 (1925) the United States Board of Tax Appeals provided that under section 234(a) of the Revenue Act of 1918 (a predecessor of section 162) a corporate taxpayer may not deduct as an ordinary and necessary expense more than a reasonable amount for compensation for its president. The Board of Tax Appeals refuted the Taxpayer's contention that the Commissioner had no authority to determine what was a reasonable amount of compensation. The Board of Tax Appeals stated that "the Commissioner not only has the authority but it is his duty to determine under all the facts obtainable the reasonableness or unreasonableness of deductions by a corporate taxpayer of compensation paid." Section 234(a) of the Revenue Act of 1918 provided:

> That in computing net income there shall be allowed as deductions all 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 * * *

In *Geiger & Peters, Inc. v. Commissioner*, 27 T.C. 911 (1957), the Tax Court found that the amounts claimed as deductions for officers' salaries were reasonable under section 23(a), Internal Revenue Code of 1939 (a predecessor of section 162). The Tax Court stated at pp 920-921:

> The second issue presented is whether the amounts of salary paid or credited to the accounts of Harold and Oscar, respectively, were 'reasonable' within the meaning of section 23(a)(1)(A), Internal Revenue

> Code of 1939. The burden of proving reasonableness is upon petitioner. *Botany Worsted Mills v. United States*, 278 U.S. 282. It is well settled that the question of what constitutes reasonable compensation to a specific officer of a corporation is essentially a question of fact to be determined by the peculiar facts and circumstances of each particular case. *Miller Mfg. Co. v. Commissioner*, 149 F.2d 421. Among the factors which are to be considered, but not necessarily with equal importance, are the type and extent of services rendered by the employee; the scarcity of qualified employees for the particular position; the volume and amount of the taxpayer's business, including its special or peculiar characteristics, if any; the prevailing compensation paid to employees performing similar services in other comparable enterprises; and the general economic conditions. *Mayson Manufacturing Co. v. Commissioner*, 178 F.2d 115. *See* 4 Mertens, Law of Federal Income Taxation sec. 25.69.

In *Pepsi-Cola Bottling Co. of Salina, Inc. v. Commissioner*, 61 T.C. 564 (1974), ***aff'd*** 528 F.2d 176, (10th Cir., 1975) the sole executive officer of a corporation had been compensated for the years in issue under a corporate resolution which had remained unchanged for 12, 13, and 14 years, respectively, and which was no longer realistic because of related changing factors and circumstances. In this case, the compensation was contingent compensation. The Tax Court disagreed with both the taxpayer's and the Service's determination of the reasonable compensation deductible under section 162 of the Internal Revenue Code of 1954 and made its own determination of what was reasonable.

In *Switz v. Commissioner*, T.C. Memo. 1979-162 (April 24, 1979), the taxpayer rented property from a bank the taxpayer then subleased to his corporation. The taxpayer charged his corporation more rent than was due under the lease with the bank. Taxpayer's corporation attempted to deduct this amount under 162 as rent, or alternatively as compensation from the corporation paid to the taxpayer. The Tax Court agreed with the Service that these payments are not deductible since they were neither paid nor intended as compensation. The Tax Court stated that:

> The test of deductibility for compensation payments is whether they are reasonable and are in fact paid purely for services. Section 1.162-7(a), Income Tax Regs. The payment must be paid and intended as compensation. *Jefferson Block & Supply Co. v. Commissioner*, 59 T.C. 625, 633–634 (1973), *affd.* 492 F. 2d 1243 (6th Cir. 1974). Whether this intent has been shown is a factual question to be decided on the basis of the particular facts and circumstances of the case. *Electric & Neon, Inc. v. Commissioner*, 56 T.C. 1324, 1340 (1971), *affd. without opinion*, 496 F. 2d 876 (5th Cir. 1974). The burden of proof is on petitioner, *Welch v. Helvering*, 290 U.S. 111 (1933).

Second Issue: Once it is determined what payments made to by are not deductible under section 162, regardless as to their characterization by the parties,

the question becomes how these excess nondeductible payments should be taxed. Are the payments gifts, dividends, or just additional compensation that is not deductible to but taxable at ordinary income tax rates to . This question is also fact specific and addressed by not only section 1.162-7 but also sections 1.162-8 and -9. You have indicated that in , the "Other Income" was taxed at ordinary income tax rates to , but this income was characterized as dividends in . [redacted]

I found only 16 cases interpreting section 1.162-8. Most of these cases also interpret section 1.162-7. There are approximately 63 cases addressing the treatment of bonuses under section 1.162-9, most of which also address section 1.162-7. Since this case does not involve bonuses, I did not provide cases focused on bonuses. Please note, however, that *Elliot* discussed in *Rapco, supra*, and *Caledonia* and *Garrison* discussed below, do involve bonuses.

I set forth *Caledonia* and *Garrison* below because *Caledonia* would have been appealable to the Second Circuit and Garrison is a T.C. opinion. Both cases discuss in detail factors to be considered in determining the nature of excess compensation paid from a closely held company to shareholders. I also included a revenue ruling discussing the treatment of excess compensation not deductible under section 162 as dividends.

The District Court in *Caledonian Record Pub. Co., Inc. v. U.S.*, 579 F. Supp. 449 (D. Vermont 1983) analyzed excess compensation payments to multiple family members having an interest in the corporation. With respect to excess payments to a controlling shareholder, the District Court provided at pp 460-461:

> When a case involves a closely held corporation where the controlling shareholder-executives set their own compensation, close scrutiny is necessitated to ascertain whether such alleged compensation is in fact a distribution of corporate profits. *Levenson and Klein, Inc. v. Commissioner*, 67 T.C. 694, 709 (1977); *Perlmutter v. Commissioner*, 373 F.2d 45, 47 (10th Cir.1967).
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> 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.

> 26 C.F.R. § 1.162–7(b)(1). This regulation summarizes a collection of cases which over the years have determined that ostensible salaries paid to controlling shareholders of corporations are in reality disguised dividend payments. The advantage of such excessive salary payments is clear; compensation or wages represent a deductible expense to the corporation while dividend payments do not. The fact that a closely held corporation does not make regular distributions of profits is an additional warning that excessive compensation to a shareholder/employee may in fact be a disguised dividend. *Mayson Mfg. Co. v. Commissioner, supra*, 178 F.2d at 119; Rev. Rul. 79–8.
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> The failure of a closely held corporation to pay more than an insubstantial portion of its earnings as dividends on its stock is a very significant factor to be taken into account in determining the deductibility of compensation paid by the corporation to its shareholder/employees. Rev. Rul. 79–8; *see Mayson Mfg. Co. v. Commissioner, supra*, 178 F.2d at 119.6

In *Garrison v. Commissioner*, 52 T.C. 281 (May 15, 1969), the principal stockholder-officer-employee of a corporation received a purported $40,000 bonus for his services. The bonus was authorized and paid after the corporation had determined to liquidate, ceased doing business, and sold its operating assets. On audit of the corporation's return, the Service disallowed $15,000 of the bonus as excessive compensation and the corporation conceded the disallowance. The Tax Court held that $15,000 constituted a distribution in complete liquidation in respect of the stockholder-officer-employee's stock within the meaning of section 331(a) of the Internal Revenue Code of 1954. The Tax Court explained at pp 284-285 that:

> Various unsuccessful attempts have been made to characterize amounts disallowed as excessive compensation as nontaxable receipts in the hands of the recipients. Thus, such amounts have been refused the status of gifts. *Lengsfield v. Commissioner*, 241 F.2d 508 (C.A. 5, 1957); *Smith v. Manning*, 189 F.2d 345 (C.A. 3, 1951); *Stanley B. Wood*, 6 T.C. 930 (1946). Similarly, such payments have not been considered repayments of loans. *D. J. Jorden*, 11 T.C. 914 (1948). Likewise, an attempt to classify such a payment by one subsidiary corporation to a second subsidiary corporation as a constructive dividend to the parent and a contribution to capital of the second subsidiary has also failed. *Sterno Sales Corporation v. United States*, 345 F.2d 552 (Ct. Cl. 1965); cf. *Zeunen Corporation v. United States*, 227 F. Supp. 952 (E.D. Mich. 1964).
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> A careful reading of these cases reveals that excessive compensation does not, as a matter of law, retain that characterization for tax purposes in the hands of the recipient. Nor must it necessarily be considered something other than compensation. Neither the label initially affixed by the taxpayer nor the failure of the respondent to provide an alternative

> label for the disallowed payment is conclusive. The touchstone for decision is a factual determination as to the actual nature of the payment in question under all the circumstances, free from any compulsory inhibitions stemming from the designations of the parties. As the Court of Appeals stated in *Lengsfield v. Commissioner, supra:*
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> Whether or not a corporate distribution is a dividend or something else, such as a gift, compensation for services, repayment of a loan, interest on a loan, or payment for property purchased, presents a question of fact to be determined in each case. * * * (See 241 F.2d at 510.)
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> Respondent's regulations recognize the factual foundation for such a determination in the case of distributions by an ongoing corporation. Secs. 1.162-7(b)(1) and 1.162-8, Income Tax Regs. We perceive no valid reason for not applying the rationale of those regulations in a situation involving the liquidation of a corporation. *Cf. Robert Gage Coal Co.*, 2 T.C. 488, 500-502 (1943); *Jas J. Gravely*, 44 B.T.A. 722, 728 (1941). The standard to be applied is not unlike the 'net effect' test employed in determining whether distributions are essentially equivalent to a dividend. *Cf., e.g., Woodworth v. Commissioner*, 218 F.2d 719 (C.A. 6, 1955), *affirming* a Memorandum Opinion of this Court; *Flanagan v. Helvering*, 116 F.2d 937 (C.A.D.C. 1940), affirming a Memorandum Opinion of this Court; *see Levin v. Commissioner*, 385 F.2d 521, 524 (C.A. 1, 1967), affirming 47 T.C. 258 (1966).

Rev. Rul. 79-8, 1979-1 C.B. 92, holds that the failure of a closely held corporation to pay more than an insubstantial portion of its earnings as dividends on its stock is a very significant factor to be taken into account in determining the deductibility of compensation paid by the corporation to its shareholder-employees. Conversely, where after an examination of all of the facts and circumstances (including the corporation's dividend history), compensation paid to shareholder-employees is found to be reasonable in amount and paid for services rendered, deductions for such compensation under section 162(a) will not be denied on the sole ground that the corporation has not paid more than an insubstantial portion of its earnings as dividends on its outstanding stock.

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