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'Management Fee' Deductions Disallowed: '*Aspro, Inc. v. Commissioner*'

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The label assigned to a payment may not be respected in determining U.S. income tax consequences, if, based on the surrounding facts and circumstances, the label is inconsistent with the substance. *Aspro, Inc. v. Commissioner* (TC Memo 2021-8) illustrates how application of this principle can result in disallowance of claimed deductions (in that case, for millions of dollars of management fees) and underscores issues that should be considered in designing arrangements to compensate enterprise owners or related parties for their services.

Facts in Aspro

Aspro, Inc. (Aspro), a closely held corporation with three shareholders, operated an asphalt paving business in Iowa. Two of the shareholders were corporations, and each owned 40% of the stock of Aspro. The third shareholder, an individual, Milton Dakovich, owned 20% of the stock of Aspro and, as Aspro's chief executive officer, was responsible for day-to-day management of its business. He received salary, annual bonus, and director's fees for service on the board of directors of Aspro, in addition to a portion of the management fees discussed below.

Aspro used the accrual method of accounting and filed tax returns as a C corporation on the basis of a fiscal year ending November 30. During the fiscal years at issue (ending November 30 of 2012 through 2014), Aspro had 60 to 75 employees and reported annual sales ranging from $22.48 million to $25.93 million, but comparatively modest taxable income ranging from $0.14 million for 2012 to $0.52 million for 2014.

Although Aspro paid no dividends to its shareholders during those years or any prior years, it did pay management fees to its shareholders near the end of each year, ranging from $1.17 million in 2012 to $1.8 million in 2014. Approximately 9% to 14% of the annual management fee for each year was paid to Mr. Dakovich; the balance of the management fees for each year was divided equally between the two other shareholders.

The IRS determined a tax deficiency for each of the years at issue, based on complete disallowance of the deductions claimed for management fees, and Aspro filed a petition for review.

Discussion

With some exceptions, reasonable compensation for personal services paid in a trade or business is deductible as a business expense under IRC section 162(a). The Tax Court decision upheld the denial of the management fee deductions, however, on two alternative grounds: (1) that the management fees, whether or not reasonable in relation to the services rendered, were in this case disguised distributions to shareholders and therefore nondeductible dividends, and (2) that Aspro was unable to establish that the amounts paid were reasonable in relation to services provided either by the corporate shareholders or by Mr. Dakovich.

The opinion first observed, on the basis of cases and the Treasury Regulations, that courts closely scrutinize payments by a closely held corporation to its shareholders. In particular, Reg. section 1.162-7(b)(1) provides in part: "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," with rechararacterization being likely if the salaries are in excess of amounts ordinarily paid for similar services and the payments bear a close relationship to the stock ownership.

Circumstances that weighed heavily against Aspro included that, although the management fees were not paid in exact proportion to stock ownership, the two shareholders other than Mr. Dakovich always received amounts equal to each other, and that, overall, the division of the management fee payments among the shareholders roughly corresponded to their ownership interests. Moreover, although individuals who were shareholders of, or employees of affiliates of, the corporations did provide certain services during the years at issue to Aspro, one of the corporate shareholders was a holding company with no operations or employees, the other was engaged in a completely unrelated business, and neither provided services directly. While that might not have been a major obstacle to treatment of the payments as deductible expenses if the corporate shareholders had entered into agreements with Aspro to provide services through shareholders or other affiliates, there were no such written agreements.

Other factors noted by the court as undermining treatment of the payments as management fees included that the fees were paid in a lump sum at the end of each tax year, rather than periodically as services were performed; and that Aspro reported relatively little taxable income after deduction of the fees. Further, none of the witnesses in the proceedings before the Tax Court was able to explain how the management fees were determined. The opinion observed (citing case law) that the unstructured manner in which management fees were determined was a further indication that they were paid as a means of distributing earnings to shareholders.

Regarding the reasonableness of the fees, Aspro apparently asserted that the fees paid to the corporate shareholders were in consideration of various services provided by shareholders and employees of affiliates of both of those corporations, including advice and other services relating to bidding on specific jobs, lobbying, human resources, environmental matters, and investment management.

The opinion characterized Aspro's rationale for the deduction of the fees paid to corporate shareholders as a "last-minute scramble to list everything anyone remotely associated with either shareholder did for petitioner." More concretely, the court observed that no evidence was introduced that such advice was provided on behalf of the corporate shareholders, or as to what portion of the management fees represented reasonable compensation for each of these services, the time expended by various individuals on these matters, and additional costs, if any, incurred by the affiliates to provide these services. There were also no written agreements between Aspro or its shareholders and the affiliated persons actually providing the services in respect of Aspro-related advice and services.

In regard to whether the management fee amounts paid to Mr. Dakovich constituted ordinary, necessary, and reasonable compensation for services, the Tax Court noted that many courts have applied a multi-factor test to determine the reasonableness of compensation purportedly paid to a shareholder for services. Criteria found to be relevant under such tests have included the nature and scope of the employee/shareholder's work, the size of the business, and prevailing rates of compensation for non-shareholder employees providing comparable services to comparable businesses. Other courts have concluded that the predominant, or perhaps exclusive, test for deductibility should be the independent investor test -- namely, whether an independent investor would have approved such compensation as consistent with a fair return on such shareholder's investment.

The court concluded that the management fees paid to Mr. Dakovich exceeded reasonable compensation under either standard, taking into account salary and bonus amounts paid to him for his service as an executive. In respect of the multi-factor standard, the court found to be persuasive a report prepared by the government's expert which concluded that companies in Aspro's industry paid, on average, annual compensation to their chief executive officers significantly less than the salary and annual bonus Mr. Dakovich received apart from the management fees.

The court also found to be convincing the assertion in the report of the government expert that, although Aspro had healthy operating margins before taking into account the management fees in comparison to other companies in the same industry, its profits after subtraction of the management fees were weak in comparison to industry peers, such that, in the court's view, a hypothetical investor would not have found the resulting investment returns to be reasonable. Aspro did not provide any evidence or expert testimony on this issue.

Observations

Under the facts and circumstances set forth in the *Aspro* decision, the conclusion reached by the Tax Court is unsurprising.

As it should be expected that the government will continue to bring these cases, corporations are well advised to review management fee arrangements with shareholders or affiliated persons and to confirm that the arrangements are properly documented, with agreements that identity the services to be provided and the persons to provide those services and that describe the computation of payments for those services. Through board of directors' minutes, information from third parties, or otherwise, there should be substantiation for the anticipated payments and for the overall reasonableness of the arrangements in relation to the value of the services provided and industry practice. Payments to shareholders, purportedly for services, but made in proportion to stock ownership, should generally be avoided. It is also important that reasonable dividends be paid.

In situations where there is flexibility as to the tax classification of the entity conducting the business, the owners may want to consider conducting the business through a pass-through entity classified as a partnership for income tax purposes. In that context, disguised dividend issues and challenges to the reasonableness of compensation paid to owners or their affiliates are less likely to be raised.

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