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Compensating Family Members: A Survey of Major Tax Planning Problems and Opportunities on the Family Farm

by

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I. INTRODUCTION

It is not unusual for a farm, ranch, or other agricultural enterprise to receive substantial services from several members of an immediate family. Usually one member acts as "manager." This "manager" will often be assisted by the efforts of a spouse whose role frequently approaches that of a full-fledged partner in terms of the quantity and quality of the work. Indeed, major assets of the enterprise, such as land, may be co-owned by the spouses. Moreover, any children of the family are likely, when old enough, to be involved in the operation of the family enterprise. The services of these children, even though thought of as no more than "chores," may be of substantial value to the enterprise.

To the extent that the services of the nonmanager family members are uncompensated, or undercompensated, it is quite possible that the family as a unit is paying a greater portion of its income as federal taxes than would be the case with proper compensation planning. This article surveys some of the major opportunities for family unit tax savings, as well as major problems which may arise, by the use of various compensation arrangements. These arrangements will be contrasted in the context of the major forms of business in which the agricultural enterprise is likely to be conducted. Some of the opportunities and problems have previously existed, while others have been created by recent legislation, such as the Economic Recovery Tax Act of 1981,

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the Tax Equity and Fiscal Responsibility Act of 1982, the Technical Corrections Act of 1982, the Subchapter S Revision Act of 1982, and the Social Security Act Amendments of 1983. Some of the considerations discussed in this article are peculiar to the agricultural sphere, and they will be noted. Most considerations, however, are applicable to family-operated businesses in other spheres, and, to that extent, this article is relevant to other family businesses as well.

II. INCOME SHIFTING BY PAYMENTS FOR SERVICES

A. General Tax Effects of Income Shifting

The individual income tax is computed under the direction of section 1 of the Internal Revenue Code. Rate schedules applicable to various classes of individual taxpayers are provided in a series of subsections. The tax owed by a married couple filing a joint return, for example, is computed under section 1(a). If a husband and wife file separate returns, each spouse computes his or her tax under section 1(d). Most unmarried individuals, including children who have income, use the schedule in section 1(c). The schedule found in section 1(b) is provided for certain unmarried individuals who are considered "heads of households."

The various schedules are different in content but similar in design. Each is a *progressive* schedule in which income is divided into a stack of slices, or "brackets," of income with a flat rate of tax being applied to each bracket. As the amount of income subject to the schedule increases, more of the brackets in the stack are involved. The rate applicable to a given bracket is higher than the rates applicable to brackets lower in the stack and lower than the rates applicable to brackets higher in the stack.

The importance of this design is that the income tax consequences of a shift of income to or from an individual are generally computed with reference to the highest bracket or brackets involved. For example, if a father's top slice or bracket of income is taxed at a flat rate of 50% and his son's top bracket rate is only 11%, every dollar shifted from father's top bracket to son's top bracket will represent a decrease in the income tax payable on that one dollar of thirty-

nine cents (50% less 11%). Since the son may use the dollar to defray expenses that would otherwise have been satisfied by the father, the family unit may very well receive the same benefit at a lower tax cost.

Wage payments to the nonmanager spouse would not produce the same direct tax savings. Section 1(a) is designed to produce the same tax whether the income reported on a joint return was earned by one spouse only or was earned in part by each. Filing separate returns will not avoid this result. Section 1(d) will produce the same total tax if the taxable incomes are exactly equal. For example, $40,000 of taxable income reported on a 1983 joint return would produce a tax of $8304 without regard to whether the income was earned by the husband, by the wife, or by both in combination.[1] Taxable incomes of $20,000 each reported by a husband and wife on separate returns would produce a tax of $4152 each, for a total of $8304.[2] If the taxable incomes are not equal, however, filing separately will usually produce a *higher* tax than if a joint return were filed. For example, if the same $40,000 were reported $30,000 by husband and $10,000 by wife on separate returns, husband's tax would be $8007 and wife's tax would be $1446, for a total of $9453.[3] This is $1149 higher than the tax ($8304) applicable to $40,000 on the joint return. Thus, in order to make payments to a spouse advantageous from a tax standpoint, there would have to be some other objective in mind.

In the case of payments to children, other tax savings may result in addition to those effected by lowering the applicable tax rates. Each individual taxpayer is allowed a deduction, called a "personal exemption," of $1000.[4] This means that up to the first $1000 of a taxpayer's income will not be taxed because it is offset by the personal exemption. A taxpayer is also allowed an additional exemption in like amount "for each dependent."[5] These two exemptions may

1. *See* I.R.C. § 1(a)(2).
2. *See* I.R.C. § 1(d)(2).
3. *See* I.R.C. § 1(d)(2).
4. I.R.C. § 151(b).
5. I.R.C. § 151(e).

not be mutually exclusive. A child who has income may be able to utilize his or her personal exemption even though the parent remains entitled to a dependent's exemption for that child.[6] This would have the effect of allowing two exemptions for the same child and thus create an additional $1000 in tax-sheltered income. This double benefit is not available in the case of spouses. Although each spouse has a personal exemption, regardless of whether or not a joint return or separate return is filed,[7] one spouse cannot be the dependent of another for purposes of claiming a dependent's exemption.[8]

Parents generally may claim the dependent's exemption for any child who has gross income of less than $1000 during the year as long as the parents provide more than one-half of the support furnished such child during the taxable year.[9] If the child is under the age of nineteen or is a student, the parent who furnishes over one-half of such child's support can generally claim the exemption even if the child's gross income exceeds $1000.[10] Thus, the support requirement is critical for children who are students or under age nineteen. Actual support furnished rather than funds available for support provides the key. Thus, if a parent pays a wage to a child, monies used by the child for support must be weighed against support furnished by the parent in determining whether the parent has furnished more than half the support of such child.[11] If the *parent* uses the child's wages for the child's support, such support will be deemed to have been provided by the *child* and not the parent.[12] However, to the extent the child does not use the wages for the child's own support, such unused wages will not be considered as having been provided by the child for the child's own support, even though they were available for such use.[13]

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6. Treas. Reg. § 1.152-1(c).
7. *See* Treas. Reg. § 1.151-1(b).
8. *See* I.R.C. § 152(a).
9. I.R.C. §§ 151(e), 152(e)(1).
10. I.R.C. § 151(e)(1).
11. Treas. Reg. § 1.152-1(a)(2)(i).
12. I.R.C. § 73(b); *see* Dick v. United States, 218 F. Supp. 839 (E.D. Wis. 1963).
13. *See* Carter v. Commissioner, 55 T.C. 109, 112 (1970), *acq.*, 1971-2 C.B. 2; *see also* Rev. Rul. 71-468, 1971-2 C.B. 115.

As a consequence, it is possible to insure that the parent is furnishing over half the child's support, regardless of the amount of wages paid to the child, by simply making certain that the child spends less for the child's own support than is furnished by the parent. For example, the child could deposit part or all of the earnings in a savings account as a way of building a future college fund. Since the tax cost of this fund will be figured at the child's tax rate rather than at the parent's, the fund will consist of tax savings to the extent of the difference.

An additional tax shelter opportunity may exist by reason of what is called the "zero bracket amount."[14] The individual rate schedules found in section 1 all contain a first bracket which is taxed at a zero rate—the "zero bracket amount." The size of the bracket varies, but it would generally be $2300 for unmarried children,[15] $3400 for a husband and wife filing a joint return,[16] and $1700 on each return for a husband and wife filing separately.[17]

If all of the family income is reported on a joint return, only the one $3400 zero bracket amount is available. If the husband and wife file separate returns, each has a $1700 zero bracket amount. The total therefore remains the same. However, each child who has income may have an additional zero bracket amount of up to $2300. For example, assume a child has $3300 of income from wages and no other income or deductions except the personal exemption. The child's taxable income would be $2300 after deducting the $1000 personal exemption.[18] The $2300 would be taxed under section 1(c) at a zero rate, with the result that no Federal income tax would be paid on any part of the original $3300. If that $3300 had instead been included with all the family income on a joint return, it would have been taxed at the parents' highest applicable rate. For example, if the highest rate applicable to the joint return were 40%, $1320 in

14. *See* I.R.C. § 63(d).
15. I.R.C. § 63(d)(2).
16. I.R.C. § 63(d)(1).
17. I.R.C. § 63(d)(3).
18. I.R.C. § 63(b)(1)(B).

taxes would be paid on the same $3300 that would have been free of tax if reported by the child.

However, if the child is claimed as a dependent on the parents' return, the income reported by the child must be "earned income"[19] to qualify for the zero bracket amount. "Earned income" for this purpose is defined as compensation for personal services actually rendered.[20] If, for example, the above $3300 constituted interest income to the child, the income is not "earned income" and the $2300 zero bracket income would be effectively eliminated. The child would be forced to add a phantom $2300 as an "unused zero bracket amount" to taxable income.[21] That would put taxable income at $4600; $2300 would not be taxed under section 1(c) because of the $2300 zero bracket amount incorporated into that schedule, but the remaining $2300 (the "real" income) would be subject to tax. Since the "unused zero bracket amount" is decreased as earned income is increased,[22] a child could take full advantage of the zero bracket amount if paid wages of at least $2300 during the taxable year.

The question then, assuming that the potential tax savings are sufficiently desirable, is how best to accomplish the shift of income from a higher- to a lower-bracket family member. This will usually involve a shift from a parent to a child. The higher-bracket parent cannot simply assign a portion of his or her earnings to the lower-bracket child and expect the assignment to be effective for tax purposes.[23] Nor, generally, can he or she simply assign earnings from income-producing property and effect a shift of taxable income in that manner.[24]

Income-producing property can itself be gifted to the lower bracket child, and that will have the effect of taxing income generated after the transfer to the transferee child.[25]

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19. *See* I.R.C. § 63(e).
20. I.R.C. § 911(d)(2).
21. I.R.C. §§ 63(b)(2), 63(e).
22. I.R.C. § 63(e)(2).
23. *See* Lucas v. Earl, 281 U.S. 111 (1930).
24. *See* Helvering v. Horst, 311 U.S. 112 (1940).
25. *See* Blair v. Commissioner, 300 U.S. 5 (1937).

The income thus shifted would be taxed at the child's top bracket rates rather than the higher top bracket rates of the transferor parent. But this approach may have unsatisfactory disadvantages since the transfer may be subject to a gift tax,[26] and the value of property gifted will likely be substantially greater than the amount of income immediately shifted. For example, if property earning ten per cent of its value per year is transferred, ten dollars in property value will produce only one dollar in income shifted during the first full year after the transfer. A family may simply not have enough income-producing property available to transfer the desired amount of income to the lower bracket member. In addition, as previously discussed, the income from the property transferred would not qualify as "earned income," and any child claimed as a dependent who had only such income would lose the advantage of the zero bracket amount.

If the manager spouse is operating the agricultural enterprise as a sole proprietorship, compensation payments for the services of children may be a preferable manner in which to effect the desired income shift. The tax rate schedules under section 1 are applied to a net figure called "taxable income." This figure represents gross income reduced by certain allowable deductions.[27] The recipient of compensation payments includes these amounts in gross income.[28] To the extent not offset by allowable deductions, these compensation payments will be included in the child's taxable income. The payor of compensation, on the other hand, may be allowed a deduction in computing the payor's net income from the enterprise, which in turn directly affects the determination of the payor's taxable income.[29] This has the effect of a dollar-for-dollar shift, since the payor's taxable income is reduced by the same dollar of compensation payment included in the gross income of the payee.

26. I.R.C. § 2501(a)(1).

27. *See* §§ 61-63.

28. I.R.C. § 61(a)(1). *See* I.R.C. § 73(a) regarding amounts received in respect of the services of a child.

29. I.R.C. § 162(a)(1).

B. Deductibility of Wage Payments to Family Members

Section 162(a) authorizes deductions for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Section 162(a)(1) provides that these deductible expenses include "a reasonable allowance for salaries or other compensation for personal services actually rendered." To be deductible, therefore, compensation payments must satisfy the general requirements of section 162(a) *and* the special requirements of section 162(a)(1).

Section 162(a) does not impose any special restrictions upon the deductibility of compensation paid to family members. Under proper circumstances a parent can deduct reasonable wages paid to a child for the child's services. Deductible wage payments can also be made to a spouse. Although the payments to the spouse will not ordinarily produce a direct income tax savings, significant indirect benefits may make the payments worthwhile.

A farmer, rancher, or other business person may deduct reasonable wages paid to his or her children if the wages are paid "for personal services actually rendered as a bona fide employee in the conduct of a trade or business, or in the production of income."[30] Similarly, a farmer or rancher may deduct wages paid to an employee spouse if a "true employer-employee relationship exists" between the payor and the spouse.[31]

The tests for deductibility in cases of payments to family members are the same as those generally applied to compensation payments to unrelated parties, and the taxpayer claiming the deduction has the burden of proof.[32] Because of the family relationship, wage payments to family members are closely scrutinized by the courts and the Internal Revenue Service to determine whether the payments were made pursuant to a bona fide employer-employee relation-

30. Rev. Rul. 72-23, 1972-1 C.B. 43 (1972).

31. FARMER'S TAX GUIDE, I.R.S. Pub. No. 225 at 11 (1982).

32. Eller v. Commissioner, 77 T.C. 934, 962 (1981).

ship.[33] A key focus of this scrutiny is on the formalities of the employer-employee relationship. The absence of an express agreement between the farmer or rancher and the "employee" family member as to the existence and terms of the employment relationship between them may be a key factor indicating that payments were made for family rather than business reasons.[34] Neglecting to keep records of hours worked and rate of pay is another frequently cited omission which indicates the absence of a genuine employment relationship.[35] Failure of the "employer" to withhold and pay any applicable Federal income and/or employment taxes on wages paid to family members is another circumstance often found in cases disallowing deductions.[36] Similarly, the failure of the employee family member to report the wage as income will probably result in loss of the employer's deduction.[37]

Whether the payments are made directly or indirectly may also be critical. A parent who is legally obligated to support a child does not lose a deduction for wages paid to that child simply because the child uses part or all of the wage for the child's own support, although such use may subject the "wage" to closer scrutiny.[38] However, if the parent purports to compensate a child by directly purchasing or providing items which otherwise fall within the parent's support obligation, such expenses are likely to be considered nondeductible family expenses.[39] The cost of furnishing meals and lodging to a minor child is a nondeductible per-

33. Furmanski v. Commissioner, T.C. Memo 1974-47, 33 T.C.M. 225, 228 (1974); *see* Rev. Rul. 73-393, 1973-2 C.B. 33 (1973).

34. *See, e.g.*, Romine v. Commissioner, 25 T.C. 859, 877 (1956), *acq.*, 1956-1 C.B. 5 (1956).

35. *See, e.g.*, Roundtree v. Commissioner, T.C. Memo 1980-117, 40 T.C.M. 151, 153 (1980); Snyder v. Commissioner, T.C. Memo 1975-221, 34 T.C.M. 965, 969 (1975).

36. *See, e.g.*, Hill v. Commissioner, T.C. Memo 1982-143, 43 T.C.M. 832, 834 (1982); Furmanski v. Commissioner, T.C. Memo 1974-47, 33 T.C.M. 225, 229 (1974).

37. *See, e.g.*, Roundtree v. Commissioner, T.C. Memo 1980-117, 40 T.C.M. 151, 153 (1980).

38. Rev. Rul. 73-393, 1973-2 C.B. 33 (1973).

39. I.R.C. § 262; *see, e.g.*, Romine v. Commissioner, 25 T.C. 859, 877 (1956), *acq.*, 1956-1 C.B. 5 (1956); Roundtree v. Commissioner, T.C. Memo 1980-117, 40 T.C.M. 151, 154 (1980).

sonal expense even where an employment relationship exists.[40]

A court is likely to determine what is a reasonable wage in terms of a reasonable hourly rate.[41] A flat stipend not based on hours worked is less likely to be considered paid for services actually rendered.[42] What is a *reasonable* hourly rate may be somewhat more difficult to determine in the family context. Minimum wage laws are not likely to serve as a ready guide. They will probably have no legal applicability to farm children employed by parents doing business in an unincorporated form, but may apply where the business has been incorporated.[43] Moreover, where services are performed by several children of varying ages, a reasonable wage as to one may not be reasonable as to all because of differences in maturity and capabilities.[44]

A farmer or rancher who wishes to make deductible wage payments to family members should give careful thought to proper substantiation of the deduction. To the extent possible, the employment of a family member should be handled with the same formalities as the employment of an unrelated party. These include settling with the prospective family-member employee the services to be performed, hours to be worked, and rate of pay. Wage payments to a family-member employee should generally be made at the same time and in the same manner as payments to other employees.[45] Records should be kept of the hours worked, serv-

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40. Rev. Rul. 73-393, 1973-2 C.B. 33.

41. *See, e.g.*, Barrier v. Commissioner, T.C. Memo 1983-258, 46 T.C.M. 100, 111 (1983).

42. *See, e.g.*, Furmanski v. Commissioner, T.C. Memo 1974-47, 33 T.C.M. 225, 229 (1974).

43. For a review of the applicability of wage and hour laws to agricultural labor generally, *see* Pedersen and Dahl, *Wage and Hour Laws: Agricultural Employment*, 3 AGRI. L.J. 366 (1981).

44. *See, e.g.*, Eller v. Commissioner, 77 T.C. 934, 963 (1981).

45. *But see* Smith v. Commissioner, T.C. Memo 1967-229, 26 T.C.M. 1160 (1967). Rancher gave cattle to his children to encourage their interest in the business. Cattle were not separated from main herd, but continued to be commingled. Rancher compensated services by feeding children's cattle. Cost of such feed was deductible as reasonable compensation for child's services. This case probably represents a limit beyond which the courts are unlikely to venture to uphold a compensation deduction in the parent-child context.

ices performed and rate of pay.

The services provided pursuant to this employment relationship should clearly benefit the business aspects of the farm or ranch. To be deductible under section 162(a), expenses must be "directly connected with or pertaining to the taxpayer's trade or business."[46] The Code expressly bars deductions for personal, living, or family expenses.[47] The typical farm setting may give rise to questions as to whether certain expenditures are primarily business or personal. Payments for services which are in the nature of household chores or which primarily benefit the family would generally constitute nondeductible personal expenses of the employer.[48] If family members are paid wages for performing a variety of services on a farm, including services which primarily benefit the family, the farmer has the burden of establishing the proper allocation of expenses between the properly deductible business expenses and the nondeductible personal expenses.[49] Failure to keep adequate records to establish such allocation can lead to disallowance of deductions.[50]

If the deduction for a wage payment to a family member is disallowed in whole or in part, the status of the payment to the recipient depends on the circumstances, and the payment is not converted to a gift simply because the deduction is not allowed the payor.[51] The intent of the payor at the time the payment is made is said to be the controlling factor.[52] If the deduction is disallowed because no employment relationship is found to exist, the payment will likely be considered a gift because of the family context.[53] If an employment relationship is found to exist and the deduction

46. Treas. Reg. § 1.162-1(a).

47. I.R.C. § 262.

48. *See* FARMER'S TAX GUIDE, I.R.S. Pub. No. 225 at 11 (1982); Denman v. Commissioner, 48 T.C. 439, 448-51 (1967).

49. FARMER'S TAX GUIDE at 11.

50. Denman v. Commissioner, 48 T.C. 439, 450 (1967).

51. Wood v. Commissioner, 6 T.C. 930 (1946); Smith v. Manning, 189 F.2d 345 (3d Cir. 1951).

52. Wood v. Commissioner, 6 T.C. 930, 932-33 (1946).

53. *See* Wright v. Commissioner, 14 B.T.A. 1337, 1339-40 (1929) (dictum).

disallowed only to the extent the payment exceeds a reasonable amount, the disallowed amount is more likely to be treated as taxable compensation to the recipient despite the disallowance of the deduction to the payor.[54] However, the very few cases which have charged family members with income despite disallowance of the wage deduction to the related payor have done so with a great deal of reluctance.[55]

The disallowance of a deduction by a sole proprietor for payments to a spouse would probably have no direct effect on the family's joint return income unless the deduction were both disallowed *and* the employee spouse forced nevertheless to include the disallowed amounts into income. This has apparently never occurred, and is highly unlikely due to the obvious Congressional intent, through implementation of the joint return provisions, to extract the same amount of tax from a married couple's income regardless of whether the income was earned by the husband, the wife, or both.

Assuming a proper allocation between business and personal services is made and properly documented, the hourly wage should reflect the farmer's or rancher's best judgment as to what like services would cost if rendered by unrelated persons of similar age and experience. The farmer or rancher involved is in the best position to make such a judgment, and a good faith determination, supported by adequate substantiation of the hours and services actually performed, is unlikely to be challenged.

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54. Treas. Reg. § 1.162-8.

55. Wood v. Commissioner, 6 T.C. 930, 933 (1946) (court indicated that donative intent could probably have been established because of relationship but noted that petitioner failed to produce even "a particle of evidence on this point"); Smith v. Manning, 189 F.2d 345, 348 (3d Cir. 1951) (court indicated that donative intent could usually be more easily established where filial relationship existed, but noted here that amounts at issue were claimed as gifts only after payor father had contested disallowance of deduction within both IRS and Tax Court); Silvers v. U.S., 37 A.F.T.R. 2d 76-1058 (N.D. Ill. 1976) (issue was before court on government's motion for summary judgment; court bound by admissions that payments intended as compensation, not gifts).

C. Payments by C Corporation to Shareholder-Employees or Family Members

One of the changes wrought by the Subchapter S Revision Act of 1982 is in terminology. The new provisions refer repeatedly to "C corporations" and "S corporations," and those terms will be used herein where appropriate.[56] Despite the substantial changes provided by the Act, the fundamental difference between the two types of corporations is the same as existed between "regular" and "Subchapter S" corporations under prior law. With some exceptions, an S corporation is not taxed at the corporate level[57] but rather at the shareholder level.[58] A C corporation, on the other hand, is a separate taxable entity which pays a tax to the extent that its income is not offset by allowable deductions.[59]

To the extent that a C corporation can distribute its earnings to the manager spouse as deductible compensation, it avoids tax at the corporate level. However, its deduction is limited to "a reasonable allowance for salaries or other compensation for personal services actually rendered."[60] If a distribution of its earnings would exceed this limitation, the corporation may have no alternative, if the earnings are not to be retained by the corporation, except to distribute the remaining earnings as a dividend to the shareholders. Although a dividend distribution is not deductible by the distributing corporation, it is includible in the gross income of the shareholder recipients.[61] A double tax results to the extent that the earnings which were taxed at the corporate level are again taxed when distributed to the shareholders as dividends.

However, if the farm or ranch is operated in corporate form, an incentive may arise to pay the nonmanager spouse compensation in order to effect an additional distribution of corporate earnings in a tax deductible manner. To avoid

56. *See, e.g.*, I.R.C. § 1361(a).
57. I.R.C. § 1363(a).
58. *See* I.R.C. § 1366.
59. *See* I.R.C. § 11.
60. I.R.C. § 162(a)(1).
61. I.R.C. §§ 61(a)(7), 301(c)(1).

double taxation, the spouse and/or children of the manager shareholder may be put on the payroll. If these nonmanager family members are actually performing business-related services for the corporate enterprise, reasonable compensation payments should be deductible by the corporation even though the payments would have represented an excess over reasonable compensation if paid to the manager spouse. To the extent that additional deductible payments can be made in this manner, the need to make nondeductible dividend distributions can be reduced.

Most cases involving the deductibility of wage payments to nonmanager spouses during the years since the effective date of the joint return provisions[62] have involved payments by closely-held corporations to the spouses of major shareholders. Section 162(a)(1) contains no special rules for payments to shareholder-employees or members of their families, and compensation payments which are both reasonable in amount and which represent payments purely for services should generally be deductible notwithstanding the relationship to the manager employee.[63]

The situations which bring into question the reasonableness of the amount or the character of the payment as in fact for services most often arise in those cases where shareholder-employees have the ability to manipulate payments for tax advantage. This is a logical result since a bona fide, arm's length, employer-employee relationship would rarely lead to compensation in an unreasonable amount or to payments disguised as compensation which actually represent dividend distributions.

Inquiries into what amounts are reasonable and/or what payments are actually for services rendered are primarily factual in nature.[64] As a result, few definitive guidelines can be inferred from either administrative or judicial activity in this area. The cases dealing with the deductibility of payments by agriculture-related corporations to shareholder-

62. Jan. 1, 1948.

63. *See generally* Treas. Reg. § 1.162-7.

64. *See, e.g.*, Miller Mfg. Co. v. Commissioner, 149 F.2d 421, 423 (4th Cir. 1945).

employees are few in number, possibly due to the fact that a very small percentage of agricultural enterprises have historically been operated in corporate form.[65]

The factors considered by the courts in compensation cases involving corporations engaged in agriculture-related activities are generally the same as those considered in cases involving corporations engaged in other types of activities. For example, in considering the reasonableness of compensation payments by a California grape-growing corporation to its president and major shareholder, the Tax Court listed the following factors as among those to be considered:

> (1) the employee's qualifications; (2) the nature, extent and scope of the employee's work; (3) the size and complexities of the business; (4) a comparison of salaries with the gross and net income of the business; (5) prevailing economic conditions; (6) the dividend history of the business; and (7) the compensation paid for comparable services in comparable businesses.[66]

The same or similar factors are often cited by courts in reasonable compensation cases involving non-agricultural corporations.[67] No single factor is deemed decisive, and all must be weighed together in view of the particular circumstances.[68] It is, however, clear that payments by a family farm corporation to a major shareholder-employer or family members will invite close scrutiny from both the Internal Revenue Service and the courts.[69]

Payments to a shareholder-employee in an amount which exceeds reasonable compensation will ordinarily be

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65. *See generally* 5 N. HARL, AGRICULTURAL LAW § 41.01[2] (1983).

66. Young v. Commissioner, T.C. Memo 1979-242, 38 T.C.M. 957, 962 (1979), *aff'd*, 650 F.2d 1083 (9th Cir. 1981); *but see* Elliots, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983), in which the court apparently adopted a new standard: whether the compensation arrangement would have been acceptable to an outside investor in terms of its effect on an equity investment in the corporation.

67. *See, e.g.*, Mayson Mfg. Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir. 1949); Pepsi-Cola Bottling Co. v. Commissioner, 61 T.C. 564, 567 (1974), *aff'd*, 528 F.2d 176 (10th Cir. 1975).

68. Young v. Commissioner, T.C. Memo 1979-242, 38 T.C.M. 957 (1979), *aff'd*, 650 F.2d 1083 (9th Cir. 1981).

69. *See* Treas. Reg. § 1.162-7(b); Young v. Commissioner, T.C. Memo 1979-242, 38 T.C.M. 957, 962 (1979), *aff'd*, 650 F.2d 1083 (9th Cir. 1981).

income to the shareholder-employee even though required to be treated as a nondeductible dividend by the corporation.[70] Where a corporation makes wage payments to the family members of a controlling shareholder, disallowance of the wage deduction may result in the shareholder being charged with dividend income to the extent of the disallowance.[71] In such a circumstance, the receipt by the family member would likely be deemed an indirect gift by the shareholder, thus preventing it from being subjected to income tax *three* times: at the corporate level, to the controlling shareholder, and to the recipient family member.

One possible way to plan around a double-tax result in the case of payments to a shareholder-employee and/or family members is by having a pre-existing agreement between the corporation and recipient requiring the latter to repay amounts subsequently determined not to be deductible by the corporation.[72]

This repayment agreement should be adopted as early as possible in order to counter the possible argument that the adoption of such an agreement itself reflects knowledge that compensation is not reasonable for tax purposes.[73] In this regard, a bylaw provision would probably be best,[74] although a directors' resolution sufficiently in advance of actual payment would likely suffice.[75]

Another concern in the area of payments to share-

70. Treas. Reg. § 1.162-8.

71. *See, e.g.*, Morrison v. Commissioner, T.C. Memo 1982-613, 44 T.C.M. 1459, 1474-75 (1982); Jolly's Motor Livery Co. v. Commissioner, T.C. Memo 1957-231, 16 T.C.M. 1048, 1067 (1957).

72. *See* Oswald v. Commissioner, 49 T.C. 645 (1968), *acq.*, 1968-2 C.B. 2 (1968).

73. *See* Charles Schneider & Co. v. Commissioner, 500 F.2d 148, 155 (8th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); Saia Elec. Inc. v. Commissioner, T.C. Memo 1974-290, 33 T.C.M. 1357, 1361 (1974), *aff'd*, 536 F.2d 388 (5th Cir. 1976) (unpublished opinion), *cert. denied*, 429 U.S. 979 (1976).

74. *See* Oswald v. Commissioner, 49 T.C. 645 (1968), *acq.*, 1968-2 C.B. 2 (1968).

75. *See* Rev. Rul. 69-115, 1969-1 C.B. 50. *See also* Eugene Van Cleave v. United States, — F.2d —, 52 A.F.T.R.2d 83-6071 (6th Cir. 1983), where the shareholder was allowed relief under § 1341 when required to make a repayment to the corporation after part of its deduction had been disallowed as excessive. The IRS was willing to allow the shareholder a deduction for the repayment in the year made, but the shareholder successfully claimed a larger benefit under § 1341, which makes reference to the additional tax paid as a result of the original inclusion in income.

holder-employees or family members is section 267. That section bars the deduction of an accrued expense by a business for a payment to be made to a related party where the payment is not paid within the taxable year or two and one-half months thereafter. For example, suppose Farm Corporation is on the accrual basis and has a calendar tax year and President, a cash basis, calendar year taxpayer, owns more than 50% of the shares outstanding. On December 31, 1983, Corporation accrues a deduction for $10,000 as compensation owing, but not yet paid, to President for services rendered. Unless the amount so accrued is actually paid to President by March 15, 1984, Corporation's deduction will be lost.[76] Moreover, the deduction is not merely *deferred*, it is lost forever, even if the compensation is subsequently paid.[77]

Section 267 is of potential concern in the compensation area whenever the corporation is on the accrual basis and has a cash basis shareholder-employee who actually or constructively owns more than 50% in value of the outstanding stock. For this purpose, the nonshareholder family members are generally deemed to own constructively the stock owned by the shareholder family member.[78]

Other types of timing concerns may also exist. Assume a cash basis corporation has a fiscal year ending January 31. Compensation payments by the corporation will be deductible during the fiscal year when paid.[79] The recipients, who will ordinarily also be on the cash basis, will report the payments into income when actually or constructively received.[80] Payments made during the month of January, 1983, for example, would be deductible by the corporation for its fiscal year ending January 31, 1983, and would not be reportable by the recipient until the calendar year ending December 31, 1983. The tax advantages of deferring payments until near the end of such an overlapping fiscal year

76. I.R.C. § 267(a)(2).
77. *See* Treas. Reg. § 1.267(a)-1(b)(4).
78. I.R.C. §§ 267(c)(2), (4).
79. I.R.C. § 461(a).
80. *See* Treas. Reg. 1.451-1(a).

may encourage the payments of sizeable year-end "bonuses" in an attempt to maximize the timing advantages while insuring that corporate earnings are distributed in a deductible manner. Although such bonuses may constitute allowable deductions under appropriate circumstances,[81] bonuses which are based on a percentage of profits[82] and/or which constitute too high a percentage of corporate profits[83] may be determined to be in excess of reasonable compensation. Since the payment will likely be taxed as a dividend if it is not taxed as compensation,[84] a double tax on the same income may result.

D. Payments by S Corporation to Shareholder-Employees or Family Members

With some exceptions, an S corporation is not taxed at the corporate level.[85] Instead, shareholders report their pro rata share of corporate income directly on their returns for the taxable year in which the taxable year of the corporation ends.[86] Since new S corporations (or old Subchapter S corporations which have undergone a substantial ownership change)[87] are generally required to adopt a calendar year taxable year,[88] the taxable years of the corporation and shareholders ordinarily coincide.

An S corporation may still pay salaries to shareholder-employees. To the extent such salaries are properly deductible under section 162(a)(1), they reduce the corporate income that passes through to all shareholders in a pro rata

81. *See* TREAS. REG. 1.162-8; *see also* Elliots, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983).

82. *See* Pacific Grains, Inc. v. Commissioner, 399 F.2d 603, 607 (9th Cir. 1976); Young v. Commissioner, T.C. Memo 1979-242, 38 T.C.M. 957, 963 (1979), *aff'd* 650 F.2d 1083 (9th Cir. 1981); Em. H. Mettler & Sons v. Commissioner, 8 T.C.M. 329 (1949); Currier Farms, Inc. v. Commissioner, 7 T.C.M. 667 (1948).

83. Pacific Grains, Inc. v. Commissioner, 399 F.2d 603, 607 (9th Cir. 1968); Young v. Commissioner, T.C. Memo 1979-242, 38 T.C.M. 957, 964 (1979), *aff'd*, 650 F.2d 1083 (9th Cir. 1981).

84. *See* Treas. Reg. 1.162-8.

85. I.R.C. § 1363(a).

86. *See* I.R.C. § 1366.

87. *See* I.R.C. § 1378(c).

88. *See* I.R.C. §§ 1378(a), (b).

fashion. Shareholder-employees may thus have both salary income from the corporation in their roles as employees as well as a pro rata portion of the corporate income (reduced by such salaries) in their roles as shareholders. The status of the income to the shareholder as compensation or pass-through of corporate income may affect its character as reported by the shareholder. For example, if part of the corporation's income consists of capital gains, the character of that income is ordinarily retained in the pass-through to the shareholder.[89] On the other hand, to the extent the shareholder receives income as compensation for services, the payment will constitute ordinary income.[90]

The absence in the S corporation of the double tax aspect which characterizes dividend distributions from C corporations may have an effect on the perspective of both the IRS and taxpayers. In C corporations there is an incentive in closely held corporations to increase the salaries of shareholder-employees beyond the limits of reasonable compensation in order to effect a *deductible* distribution of corporate earnings and profits instead of utilizing nondeductible dividend distributions.

In an S corporation, however, the incentive is often to pay *less* than reasonable value for services rendered. Since the shareholder-employees will be taxed directly on corporate income, they may want to minimize or eliminate salaries in order to avoid the federal employment tax liability that attaches to the payment of "wages."[91] For example, in one situation two shareholder-employees of an S corporation decided not to pay themselves salaries for their services in order to escape liability for income tax withholding and payment of federal employment taxes. Instead, they made "dividend" distributions to themselves in lieu of salaries. The IRS ruled that these distributions would be treated as "wages" for purposes of income tax withholding and federal

89. *See* I.R.C. § 1366(b).

90. *See* I.R.C. § 61(a)(1). This type of compensation income does not qualify for capital gains treatment under any of the applicable Code provisions.

91. *See infra* notes 158-193 and accompanying text.

employment taxes.[92]

Avoidance of employment tax liability is not the only incentive to reduce salaries to shareholder-employees. If the S corporation has substantial capital gains during a year (and assuming a corporate-level tax is not thereby triggered)[93] paying the shareholders and/or family members too much compensation may convert the capital gain the shareholder would have reported[94] into ordinary income.[95]

Moreover, timing considerations may suggest attempting to minimize compensation payments in a given year. For example, if the S corporation has been able to adopt or retain a fiscal year which is not a calendar year, the pass-through of corporate income normally occurs in the shareholder's taxable year within which the S corporation's taxable year ends.[96] Thus, for example, if the corporation's fiscal year ends January 31, 1983, the shareholder would ordinarily report his or her pro rata share of corporate income into personal income during the calendar year 1983 even though eleven months of the corporation's fiscal year overlapped 1982. On the other hand, the compensation payments would ordinarily be reported by the taxpayer when actually or constructively received.[97] Compensation payments made to the shareholder and/or family members during 1982 would therefore be reported by them during 1982, while the shareholder's pro rata share of corporate income for the fiscal year ending January 31, 1983, would not be reported until the calendar year ending December 31, 1983.

The incentive also exists to minimize salaries of certain shareholder-employees in order to shift income to other lower-bracket shareholders. For example, assume Farm S corporation is owned equally by Father and Minor Son. During the tax year corporation pays Father $10,000 salary although reasonable compensation for his services would be

92. Rev. Rul. 74-44, 1974-1 C.B. 287.
93. *See* I.R.C. § 1374.
94. *See* I.R.C. § 1366(b).
95. *See* I.R.C. § 61(a)(1).
96. *See* I.R.C. § 1366(a)(1).
97. *See* Treas. Reg. 1.451-1(a).

$30,000. Corporation has $70,000 taxable income after deducting Father's salary. Without more, Father and Son, who performed no services, would each be taxed directly on $35,000 of corporate income. Father's total income from the corporation is thus $45,000 while Son's is $35,000. However, if Father had drawn a reasonable salary of $30,000, the corporate taxable income would have been $50,000, and Father and son would each report half of the $50,000 on their personal returns. Father's total would thus be $55,000 ($30,000 plus $25,000) while Son's would be only $25,000. If the salary minimization scheme worked, Father would have successfully shifted $10,000 of what otherwise should have been his proper total income to Minor Son, who presumably would be in a much lower tax bracket.

However, the Code, both before[98] and after[99] the Subchapter S Revision Act, provides the Internal Revenue Service with the express authority to reallocate the shareholders' share of corporate income in order to reflect a proper value for services rendered by a shareholder-employee of a family corporation.[100] Therefore, in the example above, the IRS would have the discretion to force Father to include an additional $10,000 in his income to reflect the total he would have received had he been properly compensated for his services.[101] Son's taxable share would be correspondingly reduced.[102] Assuming Son actually received the full $35,000, notwithstanding the allocation of $10,000 as additional income to Father, Father would presumably be treated as hav-

98. *See* former § 1375(c).

99. I.R.C. § 1366(e). This subsection contains the substance of what was formerly § 1375(c).

100. The courts use the same criteria in determining what is reasonable compensation for purposes of possible *increase* in the share allocable to certain shareholder - employees of S corporations as in determining reasonable compensation for purposes of deductibility under § 162(a)(1). *See* Roob v. Commissioner, 50 T.C. 891, 898 (1968).

101. *See* example at Treas. Reg. § 11.375-3(c), which related to former I.R.C. § 1375(c) before its substance was shifted to I.R.C. § 1366(e) by the Subchapter S Revision Act of 1982.

102. *See* Roob v. Commissioner, 50 T.C. 891, 895 (1968); Krahenbuhl v. Commissioner, T.C. Memo 1968-34, 27 T.C.M. 155, 157 (1968).

ing made a gift of $10,000 to Son.[103]

Since the possibility exists that the IRS may make adjustments in salary allocations to properly reflect the value of services rendered, the shareholders could enter into an agreement having the reverse effect of the one discussed earlier in connection with C corporations. That is, the agreement would provide that any shareholder whose income was *increased* as a result of an adjustment by the IRS to reflect proper compensation for services rendered would have the right to demand repayment from other shareholders whose share of corporate income was *reduced* by such readjustment. Considerations as to form and timing of such an agreement would presumably be the same as those discussed earlier.[104]

Prior to the Subchapter S Revision Act, section 267 placed the same limitations on the accrual of deductions for payments not yet made to more-than-50% shareholders as is placed on similar accruals by C corporations. A corporation would lose its accrued compensation deduction for compensation not actually paid to such shareholders unless payment was actually made within two and one-half months after the close of the corporation's fiscal year. Now, S corporations are in effect put on the cash basis for expenses owed to cash basis shareholders who actually or constructively own at least 2% in value of the corporation's outstanding stock.[105] In other words, under the new rule, an accrual basis corporation cannot deduct an expense to a 2%-or-more shareholder until the expense is included in the gross income of such shareholder as actually or constructively received. Unlike the old rule under which the deduction was lost forever if not paid within two and one-half months after the close of the corporation's fiscal year,[106] the new rule simply delays the deduction until there is a matching inclusion in income by the shareholder-employee.

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103. Roob v. Commissioner, 50 T.C. 891, 898 (1968).

104. *See supra* notes 72-75 and accompanying text.

105. I.R.C. § 267(f).

106. *See* Treas. Reg. § 1.267(a)-1(b)(4).

E. Payments by Partnership to Partner-Employees or Family Members

If the agricultural enterprise is operated as a partnership, payments to a nonpartner spouse and/or children will usually involve the same issues and considerations as those discussed in connection with S corporations. The partnership computes a taxable income, which means that its gross income can be reduced by deductions for reasonable compensation paid.[107] However, the partnership is not actually subject to tax.[108] Instead, each partner's "distributive share" of the partnership's taxable income is taxed to that partner directly[109] for "the taxable year of the partnership ending within or with the taxable year of the partner."[110] In the case of a partnership of individuals, the partnership and the partners will ordinarily have the same taxable year—the calendar year.[111] In computing the taxable income of the partnership, the compensation payments to a nonpartner spouse and/or children are deducted and thus reduce the distributive shares of partnership income which is taxable to the partners.

The issues become more difficult, however, as to the treatment of the payments to the partners, including payments to a partner spouse and/or children. The nature of the issues concerning payments by a partnership to a partner-employee will likely depend on whether the partnership is a "family partnership" covered by the special rules of section 704(e). If a family partnership is involved, the compensation issues generally concern whether *enough* compensation is being paid to certain partners for services rendered. On the other hand, if the partnership is not a family partnership within the meaning of section 704(e), the compensation issues generally concern how payments purporting to be for a partner's services will be treated for tax purposes.

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107. *See* I.R.C. § 703(a).
108. I.R.C. § 701.
109. *See* I.R.C. § 702(a)(8).
110. I.R.C. § 706(a).
111. *See* I.R.C. § 706(b)(1).

Prior to the enactment of section 707 as part of the 1954 Code, a partner generally could not be an employee of his own partnership. Compensation payments to partners for services were considered distributive shares of partnership income.[112] Section 707 adopted an entity approach as to certain transactions between partners and their partnerships. As a result, payments made by a partnership to one of its partners for services to the partnership may fall into one of three categories:[113]

(1) payments which constitute a distributive share of partnership income;[114]

(2) payments made to a partner in a transaction with a partnership other than in his capacity as a member of the partnership;[115] and

(3) guaranteed payments that are determined without reference to the income of the partnership.[116]

The tax consequences of a partnership's payments to a partner depend largely on the proper category into which it should fall. If the payment is made to the partner in his capacity as a partner, and is not a "guaranteed payment" within section 707(c), the payment is simply treated as part of the partner's distributive share of partnership income and is not deductible by the partnership.[117]

This characterization could affect the timing of income to a partner. Suppose, for example, a partnership is on a fiscal year ending January 31 and makes payments, which are considered advances against partner's distributive share of partnership profits, to a cash basis, calendar year partner during the months of February—December 1982. Such payments would not be income to the partner, if at all, until the

112. *See, e.g.*., Estate of Tilton, 8 B.T.A. 914, 917 (1927) (acq.); John A. L. Blake, 9 B.T.A. 651 (1927) (acq.); Karl Pauli, 11 B.T.A. 784 (1928); G.C.M. 2467, VII-2 C.B. 188 (1928); Rev. Rul. 55-30, 1955-1 C.B. 430.

113. *See generally* WILLIS, PENNELL, AND POSTLEWAITE, PARTNERSHIP TAXATION § 94.02 (3d Ed.).

114. *See* I.R.C. § 704(a).

115. *See* I.R.C. § 707(a).

116. *See* I.R.C. § 707(c).

117. *See* Pratt v. Commissioner, 64 T.C. 203, 210 (1975), *aff'd in part, rev'd in part*, 550 F.2d 1023 (5th Cir. 1977).

partner's tax year ending December 31, 1983 (the partner's tax year within which the partnership's fiscal year ended).[118]

The characterization of a payment as a part of a partner's distributive share of partnership profits could also affect the character of the income. For example, if part or all of the partnership income represents capital gains at the partnership level, that character is retained on the pass-through to the partners.[119] On the other hand, if the payments received by the partner constitute compensation for services, the payments will have that character to such partner—i.e., ordinary income—notwithstanding the character of partnership income.[120]

Section 707(a) governs transactions between a partnership and a partner "other than in his capacity as a member of such partnership." The section provides that such transactions shall be treated as if in fact occurring between a partner and a nonpartner. Such transactions may include the rendering of services by the partner to the partnership.[121]

Assume the same example as above, except that the partnership is on the accrual basis. If the partnership makes the payments for services by the partner, and such payments fall within section 707(a), substantially different tax results may occur. First, the tax consequences of the payments would be determined in the same manner as if the partner were not a partner at all. Thus, if the payments constituted reasonable compensation for services rendered, the partnership could deduct such payments under section 162(a)(1).[122] This would reduce the partnership income which passes through to the partners as their respective distributive shares.[123] It would also affect the timing of inclusion by the partner receiving payments. He would be required to include such compensation payments in income when actually or constructively received by him.[124] This would require the

118. *See* I.R.C. § 706(a), Treas. Reg. § 1.731-1(a)(1)(ii).
119. I.R.C. §§ 702(a)(2), (3).
120. *See* Rev. Rul. 81-301, 1981-2 C.B. 144, 145.
121. Treas. Reg. § 1.707-1(a).
122. *See, e.g.*, Rev. Rul. 81-301, 1981-2 C.B. 144, 145.
123. I.R.C. § 702(a)(8); § 702(b).
124. *See* Treas. Reg. § 1.451-1(a); *see also* Pratt v. Commissioner, 550 F.2d 1023,

partner to include the payments in income for his 1982 tax year, rather than in 1983 as would be the case if the payments were only parts of his distributive share of partnership profits.

If the partnership properly accrued a deduction for the payments for its fiscal year ending January 31, 1983, but did not actually make the payments until January, 1984, the partner would not include the payments into income until 1984. This would not prevent the earlier accrual of the deduction by the partnership since neither section 267 nor a similar rule applies to payments governed by section 707(a).[125]

The effect of the accrual of the deduction for the fiscal year ending January 31, 1983, would be to reduce the partnership income that passes through to the partners for that year. The deduction could conceivably produce a loss at the partnership level which would also pass through to the partners.[126] If the partner received the section 707(a) compensation payments in the same year as he properly reports his share of the partnership loss the payment produces, his share of loss may be available to offset his section 707(a) income.

Section 707(c) provides that certain guaranteed payments to a partner for services, in his capacity as partner, will be treated as payments to a nonpartner for purposes of section 61 and section 162(a)(1). In other words, a guaranteed payment to a partner for services will be deductible under the general rules governing compensation payments under section 162(a)(1). Assuming a payment by a partnership to a partner for services rendered is involved, determination of deductibility of a guaranteed payment under section 707(c) would generally involve the same issues as a payment under section 707(a). The character of the payment to the recipient would also be the same. Thus, a payment

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1027 (5th Cir. 1977) (reversing the Tax Court because of an I.R.S. concession on appeal that the interest owed by the partnership to partners was covered by I.R.C. § 707(a) and holding that interest payments were not includible by the partners until actually or constructively received).

125. *See* Pratt v. Commissioner, 64 T.C. 203, 208 (1975) *aff'd in part, rev'd in part*, 550 F.2d 1023 (5th Cir. 1977).

126. *See* I.R.C. § 702(a)(8).

received as compensation for services under section 707(a) is compensation income,[127] as is a guaranteed payment for services under section 707(c).[128] Compensation payments under both section 707(a) and section 707(c) would be ordinary income while a payment which constitutes a distributive share of partnership income would reflect the character of the partnership income passed through to the partners.[129]

Rather than make an outright payment for the services, if the partnership accrues a deduction for a section 707(c) guaranteed payment, the partner must include the amount deducted in income for his tax year with which or during which the partnership tax year during which the deduction was accrued ends.[130] However, there is no similar rule for section 707(a) payments, and the usual tax accounting rules would apply to the reporting of income by such partner.

As the discussion in the preceding sections indicates, the characterization of a payment as part of a partner's distributive share of partnership income, a section 707(a) payment, or a section 707(c) guaranteed payment may have significantly different tax consequences for both the partnership and the partner. Unfortunately, proper characterization may be difficult for the taxpayers involved as well as the Internal Revenue Service and the courts. The developments in one case serve as good examples of the characterization difficulties which may be encountered. In *Pratt v. Commissioner*[131] an accrual basis partnership accrued deductions for management fees to its cash basis general partners. The management fees were based on a percentage of the *gross* receipts of the partnership. The general partners did not include the fees in income for the year involved because, although accrued as a deduction by the partnership, the fees had not actually been paid to the partners. The IRS determined that the fees were neither section 707(a) nor section

127. *Id.*

128. Treas. Reg. § 1.707-1(c).

129. I.R.C. §§ 702(a), (b).

130. Treas. Reg. § 1.707-1(c); the validity of the regulation was sustained by the Tax Court in Pratt v. Commissioner, 64 T.C. 203, 212-13 (1975), *aff'd in part, rev'd in part*, 550 F.2d 1023 (5th Cir. 1977).

131. 64 T.C. 203 (1975), *aff'd in part, rev'd in part*, 550 F.2d 1023 (5th Cir. 1977).

707(c) payments, but rather constituted distributive shares of partnership income. As such, no deduction was allowed the partnership. This in turn increased the distributive share of partnership income that each partner in question was required to report. The management fees were concededly reasonable in amount and for services actually rendered. The partners contended in the Tax Court that the fees were governed by either section 707(a) or (c).

The court first determined that the fees were payable to the partners in their capacities *as partners*, and thus were not within the purview of section 707(a). The court expressed doubt that continuing payments for services such as salaries or management fees would ever come within section 707(a).[132] It surmised, without deciding, that section 707(a) was intended only to cover "those services rendered by a partner to the partnership in a specific transaction as distinguished from continuing services of the partner which would either fall within section 707(c) or be in effect a partner's withdrawal of partnership profits."[133] Turning to section 707(c), the court noted that that section referred to payments "[t]o the extent determined without regard to the income of the partnership." The court rejected the partners' arguments that fees based on a percentage of gross rentals were not determined with regard to partnership income.[134]

The Internal Revenue Service subsequently changed its position. On similar facts, it ruled that a management fee based on gross receipts was a guaranteed payment under section 707(c).[135] This ruling implied, in reviewing the legislative history, that § 707(c) was intended to exclude only payments determined by reference to partnership *profits*. A payment determined by reference to gross receipts, said the ruling, does not give the partner a share in partnership profits and may be only a means to accurately measure the value

132. *Id.*

133. 64 T.C. at 211.

134. The Tax Court's characterization of the fees as being merely distributive shares of partnership profits was affirmed on appeal. 550 F.2d 1023 (5th Cir. 1977).

135. Pratt V. Commissioner, 550 F.2d 1023, 1026-27 (5th Cir. 1977).

of the services provided.[136]

In a companion ruling,[137] the Service opined that a managerial fee based on a percentage of a partnership's daily gross income was a section 707(a) payment to a corporate "advisor general partner." The ruling emphasized that the partner involved rendered the same managerial services to the partnership that it rendered to others as a part of its regular business. In addition, its role as advisor was circumscribed and subject to supervision, and it could be relieved of its duties by the other general partners.

To generalize, a determination of the character of a payment to a partner involves a two-step process. First, a determination should be made as to whether the services are of the type the partner would normally be expected to render, as a partner, to the partnership. If not, section 707(a) would likely be controlling. If the services *are* rendered as a partner, then a determination must be made as to whether the payments constitute guaranteed payments within section 707(c). Such payments will likely be either in a fixed amount or determined by reference to a percentage of gross income. Payments determined by reference to net income would simply be a part of the partner's distributive share of partnership income.

Compensation payments by a partnership which is governed by the rules of section 704(e) may give rise to different issues. Section 704(e)(1) applies to partnerships "in which capital is a material income-producing factor." It provides that a person who owns a capital interest in such a partnership shall be recognized as a partner for tax purposes "whether or not such interest was derived by purchase or gift from any other person." Despite the heading of section 704(e) as "Family partnerships," the rule of section 704(e)(1) is a broad one which requires partnership treatment for tax purposes as to all owners of partnership capital interests in partnerships in which capital is a material income-producing factor. The typical farm or ranch would almost invariably

136. Rev. Rul. 81-300, 1981-2 C.B. 143.
137. Rev. Rul. 81-301, 1981-2 C.B. 144.

satisfy the requirement that capital be a material income-producing factor.[138]

The importance of this rule in the farm family context is that it can allow a farm family partnership to be utilized as a device to shift income from higher-bracket to lower-bracket family members even though some of those family members are not actively involved in the farm's operations. Assuming the rules of section 704(e) are satisfied, partnership interests can be transferred by gift or otherwise to lower-bracket family members, and such members will be treated as partners for tax purposes—i.e., they will report their distributive shares of partnership income.

Section 704(e)(2) contains two special rules for partnership interests (in partnerships subject to the section 704(e)(1) rule) which are acquired, or deemed acquired, by gift. The first rule in effect requires that an allocation of partnership income be made to the donor partner to reflect reasonable compensation for services rendered by the donor partner to the partnership. If the partnership does not provide for such an allocation, partnership income shall be reallocated to accomplish this allowance for the donor's services.[139] The second rule requires that no greater proportionate share of the balance be allocated to the donated capital interest than is allocable to the donor's capital interest.

For example, assume Father and Son each own (for purposes of section 704(e)(1)) a fifty percent interest in Family Farm Partnership, with Son's interest having been acquired by gift from Father. Father renders services to the partnership worth $10,000, and Son renders no services. No provision is made in the agreement for Father's services. Allocable partnership income is $100,000 and the partnership agreement requires that sixty percent of such income be allocated to Son and forty percent to Father. If the partnership agreement's allocation formula were given effect, $60,000 of income would be allocated to Son and $40,000 to Father.

138. *See, e.g.*, Woodbury v. Commissioner, 49 T.C. 180, 191 (1967); Manuel v. Commissioner, T.C. Memo. 1983-138, 45 T.C.M. 981, 985-86 (1983); Speelman v. Commissioner, T.C. Memo. 81-115, 41 T.C.M. 1085, 1087 (1981).

139. Treas. Reg. § 1.704-1(e)(3)(i)(b).

However, section 704(e)(2) would require that, for tax purposes, $10,000 first be allocated to Father as reasonable compensation for his services. Then, each would be allocated $45,000 of the remaining $90,000 for tax purposes since the partnership allocation formula would violate the second rule of section 704(e)(2) that the donated capital interest not receive a proportionately greater share than the donor's capital interest.

Section 704(e)(3) provides that a partnership interest purchased by one family member from another will be treated for purposes of section 704(e)(2) as having been acquired by gift. In other words, such a purchased interest would be subject to the two special rules of section 704(e)(2). "Family" for this purpose means a person's spouse, ancestors and lineal descendants, and any trusts for the primary benefit of such persons.[140]

As to what is *reasonable* compensation for purposes of section 704(e)(2), the regulations provide as follows:

> In determining a reasonable allowance for services rendered by the partners, consideration shall be given to all the facts and circumstances of the business, including the fact that some of the partners may have greater managerial responsibility than others. There shall also be considered the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the partnership.[141]

Because of the tax motivations involved, the issues in this area would probably involve cases where the donor partners are not fully compensated in an attempt to shift more income to the donee partners.

Assuming a partnership can avoid violation of the section 704(e)(2) requirement that a reasonable allowance first be made to the donor for services rendered, it may be advantageous to structure a portion of the return of a low-bracket family member partner as a guaranteed payment. For example, a father may assist a son or daughter into active involvement in the family farm by selling that child a one-half

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140. I.R.C. § 704(e)(3).
141. Treas. Reg. § 1.704-1(e)(3)(i)(c).

interest in the farm's assets and forming a partnership with such child. Assume the father is in a 50% bracket and the child is in a 20% bracket. Assume further that the father will scale back his involvement to the point that a reasonable allowance for his services for the year would be $10,000. If the partnership's gross income for the year is $50,000, and there are no guaranteed payments, the father would report $10,000 as the allocation for his services and each partner, father and child, would report $20,000 as his or her distributive share of the balance. The father's total partnership income of $30,000 would be taxed at his much higher marginal rate while the child's $20,000 would be taxed at the child's much lower rate.

On the other hand, if the partnership had made a guaranteed payment to the child of $20,000, assuming this was a reasonable allowance for the child's services, the taxable income of the partnership would be reduced to $30,000. The father would report $10,000 as the allocation for his services, plus $10,000 of the remaining $20,000 for a total of $20,000. The child would report the $20,000 guaranteed payments, plus $10,000 of the balance of $20,000 after allocation for the father's services, for a total of $30,000. The result would be that the father would only report $20,000 at his high tax rate while the child would report $30,000 at a lower tax rate, resulting in an overall savings for the family unit.

III. INDIVIDUAL RETIREMENT ACCOUNTS

A. Spouse

The Economic Recovery Tax Act of 1981 (ERTA)[142] made several significant changes which can effect compensation planning, including several changes relating to the Individual Retirement Arrangement (IRA). Previously, an individual could contribute and deduct the lesser of $1500 or 15% of compensation during a tax year, *if* he or she were not an active participant in another retirement plan.[143] If a taxpayer's spouse had no compensation during the year, the

142. Pub. L. No. 97-34, 1981 U.S. CODE CONG. & AD. NEWS (95 Stat.) 172.
143. Former I.R.C. § 219(b)(1).

taxpayer could contribute up to $1750 into a spousal IRA.[144]

As a result of ERTA, for tax years beginning after December 31, 1981, an individual can contribute the lesser of $2000 or 100% of compensation to an IRA even though he or she may be covered by another retirement plan.[145] As a consequence, any individual with at least $2000 of compensation can qualify for the maximum contribution deduction. The spousal IRA limit was also increased to $2250.[146] By simply paying a spouse reasonable wages of at least $2000, the maximum contribution deduction for a married couple as a unit can be increased to $4000 ($2000 for each spouse). Since this total is $1750 more than the maximum available under the spousal IRA, an additional $1750 of marital income has effectively been sheltered from immediate taxation by the wage payments.

B. Children

Since any individual with at least $2000 of compensation can contribute the maximum amount allowable into an IRA, it is also possible that an IRA could be set up for each child who earns wages on the farm. As has already been shown, a child can earn up to $3300 by using the personal exemption and zero bracket amounts without incurring any federal income tax liability. A maximum contribution by the child to an IRA could effectively defer taxes on an additional $2000. The total for the year without immediate federal tax liability could be $5300, if the child earns at least $5300 during the year, and these wages are reasonable for the services the child performs. Moreover, the earnings on the amounts set aside in the IRA are not subject to taxation until withdrawn.[147]

However, it is important to recognize the potential problems with committing money to an IRA in any particular year. While an individual can deduct the IRA contribution in the year made, and gain a tax advantage in that year,

144. Former I.R.C. § 220(b)(1).
145. I.R.C. § 219(b)(1).
146. I.R.C. § 219(c)(2).
147. I.R.C. § 408(e).

the amounts set aside will be taxable when withdrawn.[148] There is also a 10% penalty for withdrawal of any funds before age 59 1/2.[149] The same penalty applies if the amounts are borrowed or pledged as security for a loan.[150]

Thus, the family has lost use of this cash in the immediate future, which may create cash flow problems. It should also be noted that unless a child is earning at least $3300 in wages, the IRA is probably inadvisable since the child is not incurring any federal tax liability on that amount even without the IRA deduction. The IRA contribution in this situation would simply tie up the funds without additional immediate tax savings. Of course, the earnings on the IRA funds would not be taxed until withdrawn, but that advantage, when considered in light of the restrictions on availability coupled with the 10% penalty which applies to withdrawals or deemed withdrawals before the child reaches the age of 59 1/2, is likely to be too insignificant to justify the contributions.

IV. DEDUCTION FOR TWO-EARNER MARRIED COUPLES

Prior to ERTA, if both spouses had substantially equal incomes, they would be taxed more heavily, despite the joint return, than two single taxpayers earning like amounts. ERTA sought to alleviate this so-called "marriage tax penalty" by introducing a new deduction. This new deduction is based upon the earnings of the working spouse who has the lower income. Section 221 provides for a deduction which is generally 10% of the "qualified earned income" of the spouse with the lower earnings, with a maximum deduction of $3000.[151] In computing the earnings against which the 10% rate is to be applied, certain deductions must be made, including the deduction for contributions to an

148. I.R.C. § 408(d)(1).

149. I.R.C. § 408(f).

150. I.R.C. § 408(e)(3).

151. I.R.C. § 221(a). For 1982, a 5% rate was applied, thus limiting the maximum deduction to $1500.

IRA.[152] For example, assume a wife performs substantial business-related services on the farm or ranch which would justify a reasonable wage totaling $12,000 annually. If that wage were paid and were the lower "qualified earned income" of the two spouses, the deduction would be $1000, 10% of $10,000 ($12,000 less $2000 IRA deduction, assuming a contribution to an IRA was made). The wage payment would thus have created another $1000 of tax-sheltered income.

"Qualified earned income" includes compensation for services as well as profits from a business in which personal services are material income-producing factors.[153] "Qualified earned income" does not include income received by an individual in the employ of his or her spouse within the meaning of section 3121(b)(3)(A) of the Federal Insurance Contribution Act (FICA).[154] Section 3121(b)(3)(A) excludes from FICA coverage "services performed by an individual in the employ of his spouse."[155] Presumably, therefore, the earnings would be excluded from coverage under section 221 only to the extent they are excluded from the *exemption* from FICA coverage by reason of section 3121(b)(3)(A).

Services by an employee spouse to a sole proprietor would clearly not generate earnings qualifying for the deduction under section 221. However, the regulations under section 3121 provide that services in the employ of a corporation are *not* within the FICA coverage exemption,[156] and earnings from such services would therefore presumably constitute "qualified earned income" under section 221. Since no distinction is made between C corporations and S corporations, employment by either would apparently qualify the earnings as "qualified earned income" for purposes of the section 221 deduction even if the corporation were owned and controlled by either or both spouses.

The deduction also appears to be available in the part-

152. I.R.C. § 221(b)(2).
153. *See* I.R.C. §§ 221(b)(2), 911(d)(2).
154. *See* I.R.C. § 221(b)(2)(A)(v).
155. I.R.C. § 3121(b)(3)(A).
156. Treas. Reg. § 31.3121(b)(3)-1(c).

nership context. Under the regulations, the exception from FICA coverage is available for services performed *only* in the employ of one's spouse.[157] Employment by the partnership would necessarily mean that the employee spouse was not being employed only by his or her partner spouse. As a consequence, the exemption from FICA coverage would seem unavailable, and the corollary *inclusion* as "qualified earned income" for purposes of section 221 would seem proper. It would also seem to follow that a husband and wife partnership in which services are a material income-producing factor would produce "qualified earned income" on the part of both spouses.

If the form of business is of the type to which the two-earner spouse deduction applies and if the farm is operated by a family unit, the family unit should plan to best utilize the deduction. Maximum use of the deduction can be realized if the husband and wife earn the same wage amount. For example, if the husband earns $30,000 and the wife earns only $10,000, the two-earner spouse deduction is $1000 (10% of $10,000). If, however, the husband earns $20,000 and the wife earns $20,000, the couple earns the same $40,000 total, but the two-earner spouse deduction will be increased from $1000 to $2000 (10% of $20,000). This type of wage allocation would not be available to all families since the wages to each spouse must be "reasonable." However, to the extent there is some flexibility in the compensation arrangement of the spouses, maximum use of the deduction should be considered.

V. EMPLOYMENT TAX SAVINGS

Major increases in federal employment taxes have been mandated by recent changes in the law. Some of these changes may produce significant opportunities for *immediate* tax savings from wage payments to a spouse and/or children. To fully understand the potential opportunities, it is necessary to review the purposes and workings of the employment tax scheme.

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157. *Id.*

Congress recently enacted legislation, the Social Security Act Amendments of 1983, which was signed by President Reagan on April 20, 1983.[158] This legislation mandated major increases in social security taxes, particularly for self-employed persons.

The focus of this section is on two tax sources, the Federal Insurance Contributions Act (FICA)[159] and the Self-Employment Contributions Act (SECA).[160] The Federal Insurance Contributions Act imposes a tax on both employers and employees with respect to "wages" paid to employees.[161] The Self-Employment Contributions Act imposes a separate tax on self-employed persons in lieu of the FICA tax.[162]

The "wages" of every employee, with certain statutory exceptions, are subject to two FICA taxes: (1) a tax for Old Age, Survivors, and Disability Insurance (OASDI);[163] and (2) a tax for Hospital Insurance (HI).[164] These two taxes taken together are usually referred to as "FICA" or "social security" taxes. The total tax is paid in shares. One share, the "employee's share," is imposed on the employee. The other share, the "employer's share," is a matching tax paid by the employer.[165] The employee's share for 1984 only can be partially offset by a refundable credit provided by section 3510.[166] The credit is available to employees only and is to

158. Pub. L. No. 98-21, 1983 U.S. CODE CONG. & AD. NEWS (97 Stat.) 65.
159. I.R.C., Subtitle C, Chapter 21.
160. I.R.C., Subtitle A, Chapter 2.
161. I.R.C., §§ 3101, 3111.
162. I.R.C. § 1401.
163. I.R.C. § 3101(a).
164. I.R.C. § 3101(b).
165. I.R.C. § 3101. The following chart reflects the FICA tax rates paid as the employer's and employee's shares of the total FICA tax for the years indicated:

Year	Employee	Employer	Combined
1983	6.70%	6.70%	13.4%
1984	7.00	7.00	14.0
1985	7.05	7.05	14.1
1986	7.15	7.15	14.3
1987	7.15	7.15	14.3
1988	7.51	7.51	15.02
1989	7.51	7.51	15.02
1990	7.65	7.65	15.3

166. I.R.C. § 3510(a).

be taken into account in computing the FICA tax to be withheld from the employee's wages.[167] The taxes are imposed on a base amount, which is adjusted annually to follow cost-of-living adjustments to system benefits.[168] The wage base to which these rates were to be applied in 1983 was $35,700.[169] Thus, for example, the total tax rate for 1983 was 13.4%, applied to a maximum wage base of $35,700.

The employer is required to withhold the employee's portion of the FICA tax from the employee's wages.[170] If the employer fails to do so, the employer is nevertheless liable for payment of the tax.[171] If the employer is a corporation or partnership, any person within the corporation or partnership who is responsible for withholding, accounting for, and paying over the withheld amounts to the Government can be held personally liable for any unpaid amounts.[172] However, failure of the employer to withhold and pay the employee's share of the tax does *not* relieve the employee from liability for the employee's share.[173]

The second employment tax that will be discussed is imposed on the income of self-employed persons by the Self-Employment Contributions Act (SECA).[174] The social security benefits for self-employed persons are computed on the same basis as those for employees.[175] However, the collection and payment processes are different for the self-employed since there is no "employer" to collect the tax or to pay an "employer's share" as under the FICA tax. Rather, the self-employed person generally has the responsibility of reporting and paying the full tax imposed.[176]

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167. I.R.C. § 3510(b).

168. *See* Social Security Act, § 230, as amended by Social Security Amendments of 1983, Pub. L. No. 98-21, § 111, 97 Stat. 65 (to be codified at 42 U.S.C. § 430).

169. 47 Fed. Reg. 51,003 (1982).

170. I.R.C. § 3102(a).

171. I.R.C. § 3102(b).

172. I.R.C. §§ 6671(b), 6672.

173. Treas. Reg. § 31.3102-1(c).

174. I.R.C., Subtitle A, Chapter 2.

175. The applicable benefit provisions are contained in Title II of the Social Security Amendments of 1983. Pub. L. No. 98-21 U.S. CODE CONG. & AD. NEWS (97 Stat.) 65.

176. I.R.C. § 1401; *see also* Treas. Reg. § 1.1401-1(a).

Prior to the 1983 Amendments, self-employed persons were required to pay approximately 75% of the combined employer-employee OASDI portion of the FICA tax and approximately 50% of the combined HI portion.[177] For 1983, the last year before the Amendments become effective, the total employer-employee rate under FICA was 13.4%[178] while the total SECA rate was only 9.35%.[179] An employer could deduct the employer's share of FICA, however, and that amount was not included in the employee's income, while the self-employed person received no deduction or credit for any part of the self-employment tax paid.[180]

The Social Security Amendments of 1983,[181] which raised both the FICA and SECA rates, imposed a substantially greater tax increase with respect to self-employment income than with respect to the wages of an employee. Under the 1983 Amendments, the SECA tax rates will be increased, beginning in 1984, to equal the combined employer-employee FICA rates.[182] For years 1984 through 1989, a credit is allowed against self-employment income which effectively offsets part of the SECA tax increase.[183]

When compared with the scheduled rates before the 1983 Amendments, the size of the SECA tax increases can be more fully appreciated. For example, in 1984 the new effective rate for SECA will be 11.3%, which is an increase of 21%

177. *See* former I.R.C. §§ 3101, 3111.
178. Former I.R.C. §§ 1401(a), (b).
179. Former I.R.C. § 1401.
180. *Id.*
181. *See supra* note 158.
182. I.R.C. § 1401(c).
183. The following chart illustrates the effects of the SECA tax for the years 1983 through 1989:

Year	Rate	Credit	Effective Rate
1983	9.35%	—	9.35%
1984	14.00	2.7%	11.30
1985	14.10	2.3	11.80
1986	14.30	2.0	12.30
1987	14.30	2.0	12.30
1988	15.02	2.0	13.02
1989	15.02	2.0	13.02

The credit percentages are taken from I.R.C. §§ 3101(a), (b) and 3111(a), (b), *as amended by* Pub. L. No. 98-21, 97 Stat. 65.

from the 1983 rate of 9.35%.[184] A comparison with the FICA increase is also illustrative. The percentage SECA rate increase from 1983 (9.35%) to 1989 (13.02% effective rate) will be over 39%. The percentage FICA combined rate increase from 1983 (13.4%) to 1989 (15.02%) will be less than 13%. Self-employed persons will thus clearly bear the brunt of the tax increase mandated by the 1983 Amendments.

To illustrate the effects of this rate increase on the farm family, assume the farmer's net earnings from self-employment during 1983 were $34,150. The self-employment tax for 1983 would be approximately $3193 (9.35% × $34,150). The tax on the same amount for 1984 would increase to $4781 (14% × $34,150). After application of the 2.7% credit available in 1984 (2.7% × $34,150 = $922), the net tax for 1984 would be $3859 ($4781 - $922). This would still represent a net increase in self-employment taxes over the previous year of $666 ($3859 - $3193).

Because of the significant increases in self-employment taxes, the tax may in many instances be as large a tax burden as the income tax. The nature of the SECA tax accentuates the burden since it is not a progressive tax like the income tax but rather a tax at a flat rate on the entire amount subject

184. The following table provides a comparison between the scheduled rates of I.R.C. §§ 1401(a), (b), prior and subsequent to the 1983 Amendments (the percentage increases are rounded off):

Year	Old Rates	New Effective Rates	Percentage Increase
1984	9.35%	11.30%	21%
1985	9.90	11.80	19
1986	10.00	12.30	23
1987	10.00	12.30	23
1988	10.00	13.02	30
1989	10.00	13.02	30

The following chart illustrates, as a comparison, the increases under FICA of the combined employer-employee tax rates as compared with the old law (the percentage increases are rounded off):

Year	Old Rates	New Rates	Percentage Increase
1984	13.40%	13.70%	2%
1985	14.10	14.10	—
1986	14.30	14.30	—
1987	14.30	14.30	—
1988	14.30	15.02	5
1989	14.30	15.02	—

to the tax. For example, a taxable income of $15,000 reported on a joint return will produce $2001 in income taxes under section 1(a)(3) during tax years after 1983. This includes a top bracket rate of 20%. However, the effective tax rate is only 13.34% ($2001 tax ÷ $15,000 taxable income). The net social security tax (after the credit) will reach 13.02% in 1988. Moreover, taxable income for income tax purposes may be smaller than the amount subject to the self-employment taxes. The net earnings from self-employment are combined with other income and deductions to determine taxable income. If there is no other income, the personal exemptions and any itemized deduction will necessarily produce a taxable income figure smaller than the net earnings from self-employment.

Tax savings possibilities arise because of certain statutory exceptions from the FICA tax. The most useful exceptions from the FICA tax for family compensation planning purposes are provided for certain family member employees. The FICA tax will not apply to wages paid for services performed by a person in the employ of his or her spouse, and/or by a child under 21 years of age in the employ of either parent.[185] An exception also exists for the services of a parent in the employ of his or her son or daughter if the service performed is either domestic service in or about the private home of the son or daughter (with limited exceptions) or work not in the course of the son's or daughter's trade or business.[186]

If wages paid to the spouse or child for services on the farm or ranch are deductible, they can serve to reduce the operator's net earnings from self-employment, which can also result in a smaller self-employment tax. Since the wages paid will not be subject to a corresponding FICA tax, a significant portion of the self-employment tax may be

185. I.R.C. § 3121(b)(3)(A). The term "child" for this purpose includes an adopted child, stepchild, or foster child. SOC. SEC. HANDBOOK, NO. (SSA) 77-10135R, U.S. DEP'T HEALTH, EDUC. & WELFARE §§ 927-28 (1978); *see also* Rev. Rul. 75-294, 1975-2 C.B. 411; *but see* UNEMPL. INS. REP. (CCH) ¶ 10,340.47 and new matter ¶ 17,896.

186. I.R.C. § 3121(b)(3)(B).

avoided. Using the example discussed previously, the net self-employment tax for 1984 on net earnings from self-employment of $34,150 would be $3859. If the farmer were to pay his or her spouse and/or children reasonable wages of $12,000 during the year, the wage payments, if deductible, would reduce the farmer's net earnings from self-employment to $22,150 ($34,150 - $12,000).[187] The self-employment tax would be $3101 (14% × $22,150). The credit of approximately $598 (2.7% × $22,150) would reduce the net tax to $2503. This would represent a *decrease* of $1356 ($3859 - $2503) in self-employment taxes resulting directly from the wage payments to the family members.

The reduced self-employment tax may eventually result in reduced social security benefits upon retirement. The benefit provisions are beyond the scope of this article, but it is recommended that projections as to benefit reductions be carefully made and considered before reducing the self-employment taxes in the manner discussed above. However, it should also be noted that the taxes saved could be used to build an independent retirement income on a tax-advantaged basis, such as through contributions to Individual Retirement Arrangements and/or to one of the various qualified retirement plans available, or simply to augment private savings for this purpose.

The form of business is important for purposes of these exceptions. If the services are performed for a corporation, the exceptions are not available even though the requisite family relationship exists between the employee and the controlling shareholder.[188] If the services are performed for a partnership, the exception is not available unless the requisite family relationship exists between the employee and *each* of the partners.[189] This latter provision would appear to preclude application of the exception to wages paid by a husband-wife partnership to either spouse but not to wages paid to their children under age 21.

The employment tax savings generated by wage pay-

187. *See* I.R.C. §§ 1402(a), 162(a)(1).
188. Treas. Reg. § 31.3121(b)(3)-(1)(c).
189. *Id.*

ments to family members may result in taxpayers and the Internal Revenue Service switching their traditional positions in the matter of husband-wife partnerships. Before the joint return provisions became effective in 1948, a husband and wife may have been encouraged to claim the family business was being conducted as a partnership in order to split the income between the two spouses. The IRS, on the other hand, often took the position that no such partnership existed, resulting in most or all of the family income being taxed to one spouse, at higher rates.[190] Other cases involved claims by a retired spouse that he or she had been a partner in the family business and was therefore entitled to increased social security benefits.[191] The government was usually on the opposing side of this claim as well.

Now, however, the employment tax savings produced through the employer-employee relationship of two spouses may encourage the IRS to argue that a husband-wife partnership exists. If successful, the result could be that *both* spouses would pay self-employment taxes on their shares of partnership income.[192] If these separate incomes exceed the maximum base which would have been applicable to one spouse alone, the total tax could exceed that payable if all the self-employment income had been reported by only one spouse.[193]

VI. FRINGE BENEFIT COVERAGE OF FAMILY EMPLOYEES

An employer may supply an employee with a variety of noncash benefits as part of the total consideration for the employee's services. Many of these benefits are given a favorable position under federal tax laws. The most com-

190. *See, e.g.*, Tower v. Commissioner, 3 T.C. 396 (1944); Johnston v. Commissioner, 3 T.C. 799 (1944).

191. *See, e.g.*, Powers v. Celebrezze, 230 F. Supp. 81 (D.N.D. 1964).

192. Treas. Reg. § 1.1402(a)-2(d).

193. *E.g.*, if each spouse has net earnings from self-employment for 1983 of $20,000, the self employment tax on each would be $1870 (9.35% × $20,000). The combined total would be $3740. If only one spouse reported the entire $40,000 as self-employment income of that spouse, the tax would be only $3337.95 (9.35% × $35,700).

mon tax advantage occurs when the employer is able to deduct the value of the benefit provided while the employee is not required to include that benefit in his or her gross income. The benefit value may in some cases be excluded from employment tax coverage, thus resulting in additional tax savings to both employer and employee.

Some of these benefits may be available within the context of a family employment relationship. A general overview of all statutory fringe benefits is beyond the scope of this article. However, certain benefits may be particularly adaptable to family employment in the agricultural sphere. The focus here is on meals, lodging, and medical benefits.

A. Meals and Lodging

A farm employer is likely to furnish lodging and certain meals to an employee because of a desire to make the employee's compensation arrangement more attractive, because the provision of such benefits may be for the employer's own convenience, or for both reasons. Section 162(a) allows an employer to deduct all the ordinary and necessary expenses paid or incurred by the employer in carrying on the employee's trade or business, *including* a reasonable allowance for compensation for services rendered.[194] The costs of meals and lodging furnished by the farm employer to employees may therefore be deductible whether the furnishing of the benefits is motivated by the desire to give additional compensation, is for the employer's own convenience, or both.

The employee, on the other hand, is generally required to include in income any compensation in whatever form paid "unless excluded by law."[195] Absent a statutory exclusion for such benefits, their nature as primarily compensatory or primarily for the convenience of the employer can be critical for the employee's tax purposes.[196] Fortunately, sec-

194. *See supra* notes 30-55 and accompanying text for a general discussion of § 162 requirements.

195. Treas. Reg. § 1.61-2(a)(1), (d)(1).

196. *See* Mim. 6472, 1950-1 C.B. 15, declared obselete by Rev. Rul. 67-140, 1967-1 C.B. 387.

tion 119 sets out specific standards to govern the excludibility of employer-furnished meals and lodging. If the standards are satisfied, the value of the meals and lodging received can be excluded from the employee's gross income even though the provision is in some respects compensatory.[197]

The value of lodging furnished to the employee and his or her spouse and any dependents can be excluded from gross income if three tests are met: (1) the lodging must be furnished on the business premises of the employer; (2) the lodging must be furnished for the convenience of the employer; and (3) the employee must be required to accept such lodging as a condition of employment.[198] Only two tests must be met in the case of meals: (1) the meals must be furnished on the business premises of the employer; and (2) the meals must be furnished for the convenience of the employer.[199] Section 119 is concerned with the provision of meals and lodging in kind and does not apply to cash payments or allowances for meals and lodging.[200]

Therefore, in proper circumstances, the cost of the meals and lodging provided may be deductible by the employer while the value of the benefits is not includible in the gross income of the employee. In the agricultural sphere, the value of the meals and lodging can also qualify as "noncash remuneration" so as to be exempt from both employer and employee FICA taxes.[201] The potential tax savings opportunities are thus significant.

Since section 119 refers to the provision of meals and lodging by an employer to an employee, it may be reasonable to assume that the section has no application to the provision of meals and lodging by a sole proprietor to himself or herself and family members. In that situation, the provision of food and shelter for oneself and one's family has histori-

197. *See* Treas. Reg. § 1-119-1(a)(2), (b).

198. Treas. Reg. § 1.119-1(b).

199. Treas. Reg. § 1.119-1(a)(1).

200. Commissioner v. Kowalski, 434 U.S. 77 (1977).

201. *See infra* notes 239-43, and accompanying text for a more detailed discussion.

cally not been considered to be a taxable event even in the absence of section 119.[202] The double tax benefit sought in conjunction with the provision of the benefits by an employer to an employee—i.e., claiming the expenses as a business deduction on the one hand and excluding the value from the recipient's gross income on the other—would be available in the case of a sole proprietor and others similarly treated only if the expenses were deductible as business expenses.

Preclusion of this double benefit in the case of meals and lodging furnished by a sole proprietor to himself or herself and family is apparently accomplished by section 262, which provides that no deduction for personal, living or family expenses is allowable. The regulations provide that these personal expenses include the "expenses of maintaining a household."[203] In providing meals and lodging to himself or herself and immediate family, it would generally appear that the proprietor has incurred no more than nondeductible personal expenses.

The Commissioner has in fact taken the position that a sole proprietor who lives on the business premises cannot deduct the expense of meals and lodging furnished to the proprietor and members of his or her family.[204] The Service takes the same position with respect to the provision of meals and lodging by a partnership to a partner.[205] The Service maintains that the partnership's costs for meals and lodging furnished to the partner on the business premises of the partnership are not deductible in computing the partnerships net income and that the receiving partner must include the resulting increase in partnership income in the receiving

202. This type of benefit has been referred to as "imputed income". *See* Marsh, "*Taxation of Imputed Income*," 58 POL. SCI. Q. 514 (1943). The Supreme Court, in dictum, has indicated that a tax on the rental value of owner-occupied property would be unconstitutional as a direct tax unless apportioned among the states according to population. Helvering v. Independent Life Insurance Co., 292 U.S. 371, 379 (1934). *See also* Morris v. Commissioner, 9 B.T.A. 1273, 1278 (1928) (the value of products of a farm consumed by a farmer and his or her family is excluded from gross income).

203. Treas. Reg. § 1.262-1(b)(3).

204. Rev. Rul. 80, 1953-1 C.B. 62.

205. *Id.*

partner's share of partnership profits.[206]

The Tax Court has, however, rejected this position as an absolute rule and has allowed deductions by proprietors for the costs of meals and lodging provided to themselves on the business premises where it was necessary in the operation of the business that the proprietors live on the premises and take their food there.[207] Similarly, the Tax Court has held meals and lodging furnished by a partnership to a partner under such circumstances to be both deductible by the partnership[208] and excludible from the income of the employee-partner.[209]

The Tax Court's position has generally not prevailed in other courts.[210] The argument has been that "[a] partnership is not a legal entity separate and apart from the partners" and that therefore a partnership cannot be an employer of a partner for purposes of section 119.[211] However, the Fifth Circuit Court of Appeals has disagreed with this position under the theory that when a partner renders services to the partnership, that partner becomes "an outsider" or "one who is not a partner" and thus can be an employee of the partnership for purposes of section 119.[212]

Unlike the partnership situation, an employer-employee relationship is easy to establish between a C corporation cor-

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206. *Id.*

207. Robinson v. Commissioner, 31 T.C. 65 (1958), *nonacq.*, 1959-2 C.B. 8, *rev'd*, 273 F.2d 503 (3d Cir. 1959); Doak v. Commissioner, 24 T.C. 569 (1955), *nonacq.*, 1956-1 C.B. 6, *rev'd*, 234 F.2d 704 (4th Cir. 1956). It should be noted that these cases predate enactment of § 280A, which severely limits deductions otherwise allowed relating to the use of a "dwelling unit." It would seem that § 280A would now limit a proprietor's deductions for lodging occupied on the business premises even though the Tax Court would otherwise have allowed such deductions under the general rules of § 162(a). *See infra* notes 229-38 and accompanying text.

208. Moran v. Commissioner, T.C. Memo 1955-202, 14 T.C.M. 813, *rev'd*, 236 F.2d 595 (8th Cir. 1956). The effect of the enactment of § 280A on the Tax Court's position is not certain. See *infra* notes 229-238 and accompanying text.

209. Papineau v. Commissioner, 16 T.C. 130 (1951), *nonacq.*, 1952-2 C.B. 5.

210. *See* Commissioner v. Robinson, 273 F.2d 503 (3d Cir. 1973); Wilson v. U.S., 378 F.2d 280 (Ct. Cl. 1967); U.S. v. Briggs, 238 F.2d 53 (10th Cir. 1956); Commissioner v. Moran, 236 F.2d 595 (8th Cir. 1956); Commissioner v. Doak, 234 F.2d 704 (4th Cir. 1956).

211. Wilson v. United States, 376 F.2d 280, 297 (Ct. Cl. 1967).

212. Armstrong v. Phinney, 394 F.2d 661, 663 (5th Cir. 1968). Note that the taxpayer in this case owned only 5% of the partnership.

porate employer and its employee, even if the employee is a shareholder. The incorporation of a farming operation, therefore, creates an opportunity for the enjoyment of fringe benefits which may not be available to either a sole proprietor or to the partner in a partnership. Since the "employer" and "employee" are often little more than alter egos in a small corporation, a court may require a heavier burden to establish the elements of the section 119 exclusion.[213]

The decisions involving regular corporations have generally turned on the facts of each case. One case, *Harrison v. Commissioner*,[214] probably represents the outer limits of taxpayer advantage in the meals and lodging area. This case involved a family corporation engaged in grain and dairy farming. The corporation was owned by two related husband-wife couples. All four of the shareholders were also corporate officers and employees. A resolution of the board of directors authorized the corporation to pay for the meals and lodging of its employees who were also officers. The resolution also required the officer-employees to maintain their residences on the farm and to remain on call for the convenience of the corporation. This resolution was not without substance since the Tax Court found that the corporation's operations required constant supervision and availability of personnel on a 24-hour basis to deal with varied and unpredictable farm problems.[215]

Two female officer-employees performed farm chores and managed the households. As part of their duties as corporate employees, they were to purchase groceries, prepare meals, and serve these meals to themselves, their husbands and employees who worked for the corporation during the summers. The meals were all served and consumed on the

213. Caratan v. Commissioner, 52 T.C. 960, 964 (1969). On appeal, the Ninth Circuit reversed because the Commissioner had failed to present evidence on this point. The court noted that the taxpayers had made a "prima facie showing" that the requirements of § 119 were met. Caratan v. Commissioner, 442 F.2d 606, 609 (9th Cir. 1971). Note also that the IRS refuses to issue rulings on the excludibility under § 119 of meals and lodging furnished to shareholder-employees. Rev. Proc. 83-22, 1983-13 I.R.B. 73, § 3.02.

214. T.C. Memo 1981-211, 41 T.C.M. 1384 (1981).

215. *Id.* at 1391.

farm. The corporation also paid the electric, gas, and telephone bills for the officer-employees. The corporation then deducted the expenses for the groceries, electric, gas, and telephone bills. The officer-employees, on the other hand, did not include such amounts in their gross income. The Commissioner disallowed the corporate deductions on the grounds that the payments were not ordinary and necessary expenses within the meaning of section 162(a). The gross incomes of the officer-employees were increased in the amount of the payments on the theory that the amounts constituted dividends to them.

The primary focus of the Tax Court was on the section 119 exclusion. With respect to the provision of grocery money, prior Tax Court precedent seemed to be against the taxpayers. In *Tougher v. Commissioner*,[216] the Tax Court had held that "groceries" were not the equivalent of "meals" for the purposes of the exclusion under section 119. In *Harrison*, however, the court noted that the two wives were required as *corporate employees* to purchase the groceries and prepare and serve the meals to corporate employees.[217] If the corporation had hired outsiders to buy the groceries and prepare and serve the meals, the court noted that no issue would exist as to whether "groceries" or "meals" were being furnished. The court thought that hiring the wives, although they were also officer-employees, to perform the same tasks should not alter the result.[218] The court did emphasize that because of the relationships involved, the court would have to scrutinize such arrangements carefully.[219]

Having determined that the value of the meals furnished was excludible from the gross income of the employees under section 119, the court gave short shrift to the issue of the corporation's deduction, finding that the officer-employees were needed on a 24-hour basis and that the corpo-

216. 51 T.C. 737 (1969), *aff'd per curiam*, 441 F.2d 1148 (9th Cir. 1971), *cert. denied*, 404 U.S. 856 (1971).

217. Harrison v. Commissioner, T.C. Memo 1981-211, 41 T.C.M. 1384, 1390 (1981).

218. *Id.*

219. *Id.*

ration furnished the meals and lodging in order to induce the employees to reside on the farm.[220] The meal expenses were therefore deductible.

The issues as to the provision of lodging were more complex. The corporation did not own the personal residences occupied by the shareholders. The residences were, however, located on the farm. The corporation paid the gas, electricity, and telephone bills on those residences. The court pointed out that commodities which are necessary to make a lodging habitable constitute "lodging" for purposes of section 119.[221] The court then went on to find that the gas and electricity were necessary to make the residences habitable, but that the telephone services were not.[222] Payment of the gas and electricity bills therefore constituted the provision of lodging within section 119, while payment of the telephone bills did not.

The "lodging" was thus furnished for the "convenience of the employer" because of the need for around-the-clock supervision of the farming operation. Since the residences of the officer-employees were located on the farm, the only remaining test for exclusion was that the employees be required to accept the lodging as a condition of employment. The regulations provide that the test is not met unless the employee is required to accept the lodging in order to enable the employee to properly perform the duties of his or her employment.[223] The Tax Court felt on the facts of this particular case that the employees were required to reside on the farm in order to properly perform the 24-hour supervision required. As the court pointed out, "[d]airy farming is simply not a nine-to-five business."[224] After finding the "lodging" (gas and electricity) excludible from the employees' incomes under section 119, the court also found, almost

220. *Id.*

221. *Id.* at 1391.

222. *Id.*

223. Treas. Reg. § 1.119-1(b).

224. Harrison v. Commissioner, T.C. Memo 1981-211, 41 T.C.M. 1384, 1391 (1981).

as an afterthought, that the expenses were deductible by the corporation under section 162(a).

The key fact in the *Harrison* case was the 24-hour nature of the supervision required. Presumably any family agricultural operation requiring this constant attention could also qualify if conducted in corporate form as a C corporation.[225] This decision seems to endorse the conversion of many household chores dealing with the preparation and service of meals into deductible business expenses. The deduction could be available for both the groceries themselves and for the services performed in the preparation of the meals. The decision also creates significant opportunities in connection with the furnishing of "lodging." Even though the shareholder-employees may be reluctant to transfer ownership of their personal residences to the corporation, many basic expenses incurred in making the residences "habitable" may constitute "lodging" for purposes of section 119 if paid by the corporation.

It is important to note that taxpayers must be careful to arrange the conversion of household chores and expenses properly. While in *Harrison* the unique factual circumstances worked to the taxpayer's advantage, different facts can produce the opposite result, as evidenced by the decision in *Peterson v. Commissioner*.[226] The key turning point in *Peterson* was that the taxpayer lived in town prior to the construction of a farmhouse without any inconvenience to the corporation.[227] In fact, the house construction was almost complete before the corporate resolution to provide meals and lodging was passed.[228] Thus, the court held that the exclusion should be disallowed.

225. *See also* Caratan v. Commissioner, 442 F.2d 606 (9th Cir. 1971), where the officer-employee of a farm corporation was able to exclude the value of meals and lodging where the taxpayer submitted evidence that "grape dusting, tractor work, irrigation and repairs, are often done in the evening or at night" and that farming is a 24-hour-a-day job. The Commissioner in that case, however, did not attempt to rebut the taxpayer's evidence. *See also* Wilhelm v. United States, 257 F. Supp. 16 (D. Wyo. 1966) where the taxpayer overcame the government's evidence.

226. T.C. Memo 1965-255, 24 T.C.M. 1383 (1964), *reh'g*, T.C. Memo 1966-196, 25 T.C.M. 1002 (1966).

227. 25 T.C.M. at 1010.

228. 24 T.C.M. at 1389.

The focus of the meals and lodging question changes substantially when the form of business is an S corporation rather than a C corporation. The reason for this change in focus is the passage of section 280A, which applies to individuals and S corporations but not to C corporations. The effect of this section is to disallow deductions related to a taxpayer's home unless the statute specifically states that the deduction will be allowed.[229] Section 280A(c) allows deductions for items allocable to a portion of the dwelling unit which is *exclusively* used on a *regular* basis: (1) as the principal place of business for any trade or business of the taxpayer; (2) as a place of business which is used by patients, clients, or customers in the normal course of the taxpayer's trade or business; or (3) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.[230] In addition, if the taxpayer is an employee, he or she must show that the home office is used for the convenience of the taxpayer's employer.[231] Section 280A(c) also provides for a deduction for any expense for space used to store inventory on a regular basis if the taxpayer is in the business of selling the product, but only if the dwelling unit is the "sole fixed location" of the business.[232]

The application of section 280A to a farm S corporation was at issue in the recent case of *Proskauer v. Commissioner*.[233] A subchapter S corporation deducted expenses for depreciation, utilities, gas and fuel, and insurance on a farm house owned by the corporation on the theory that the house was used for entertaining and consulting with prospective customers. However, the sole shareholders also made personal use of the house as a full-time residence, including entertaining friends who were not prospective customers. The Tax Court held that the deductions were not allowable since the house was not used *exclusively* for business purposes.[234]

229. I.R.C. § 280A.
230. I.R.C. § 280A(c)(1).
231. *Id.*
232. I.R.C. § 280A(c)(2).
233. T.C. Memo 1983-395, 46 T.C.M. 679 (1983).
234. *Id.* at 684.

The decision in *Proskauer* focused only on the deductibility to the corporation of the expenses with respect to the house. The disallowance of the deduction necessarily increased the amount of the subchapter S corporation's income which would pass through to the same shareholders. The court did not deal with the separate issue of whether section 119 has any application to the shareholder-employees. Since section 280A is literally concerned with the deductibility of certain payments, it may not have a direct bearing on whether the amounts paid in connection with a dwelling are excludible from the employee's income even though not deductible by the corporation.

It is also important to note that *Proskauer* dealt only with lodging-type expenses and not meals. Section 280A is concerned with otherwise allowable deductions "with respect to the use of a dwelling unit."[235] The section does not expressly deal with the provision of meals to employees and presumably has no direct effect on the deductibility of such expenses.

However, as a result of the Subchapter S Revision Act of 1982, section 1372(a) now provides that, for purposes of applying statutory fringe benefit rules, an S corporation will be treated as a partnership and any "2-percent shareholder" will be treated as a partner in that partnership. A "2-percent shareholder" is one who actually or constructively owns, on any day during the corporation's taxable year, more than 2% of the outstanding stock or stock possessing more than 2% of the total combined voting power.[236]

The legislative history mentions several fringe benefits which were apparently intended to be encompassed by the new rule of section 1372(a). One of the benefits specifically mentioned in the history is the exclusion for meals and lodging under section 119.[237] Thus, Congress apparently *intended* to provide that a 2-percent shareholder would *not* be an employee for purposes of section 119, while a lesser shareholder or an employee who is not a shareholder could

235. I.R.C. § 280A.
236. I.R.C. § 1372(b)(2).
237. *See* H.R. REP. NO. 826, 9th Cong., 2d Sess. 21 (1982).

be. However, an interesting question is presented by the lack of unanimity of authority on this issue in the partnership area.[238] Since at least one court believes that a partner *can* be an employee for purposes of section 119, would that same court conclude that a 2-percent shareholder could be an employee of an S corporation for the same purpose? Or would the clear expression of legislative intent with respect to section 1372(a) control?

Another interesting aspect of the provision of meals and lodging to employees is the status of such expenses for purposes of employment tax liability. Remuneration paid in any medium other than cash for agricultural labor does *not* constitute "wages" for purposes of the FICA tax.[239] The FICA regulations provide that "cash remuneration includes checks and other monetary media of exchange" but "does not include payments made in any other medium, such as lodging, food, clothing, car tokens, transportation passes or tickets, farm products, or other goods or commodities."[240]

This exception for noncash remuneration provided to agricultural employees, insofar as it applies to meals and lodging, is not linked to exclusion of the meals and lodging from the employees' gross income under section 119. This is not the case for nonagricultural labor. The Social Security Act Amendments of 1983 added section 3121(a)(19), which is effective for remuneration paid after 1983. Section 3121(a)(19) provides that the value of meals and lodging furnished by an employer for nonagricultural labor will not be considered wages for FICA purposes *if* it is reasonable to believe that the value of the meals and lodging will be excluded from the employee's income under section 119. The noncash remuneration exemption from FICA taxes may prove to be a significant additional incentive for a farm corporation to furnish its shareholder-employees meals and lodging.

This exception may not have the same effect on proprietors, partnerships, and S corporations. In the case of propri-

238. *See supra* notes 205-12 and accompanying text.
239. I.R.C. § 3121(a)(8)(A).
240. Treas. Reg. § 31.3121(a)(8)-1(f).

etors and partners, the exception should have no effect at all. The proprietor's self-employment income is not subject to the FICA tax in any event, and there is no exemption from the self-employment tax for the value of meals and lodging a proprietor furnishes to the proprietor and his or her family. The same is true for the income of a partner. Even a partner who receives "guaranteed payments" under section 707(c) is not deemed to be receiving "wages" for FICA purposes. Instead, the guaranteed payments are considered self-employment income and thus subject to the self-employment rather than the FICA tax.[241] The FICA exemption for noncash remuneration would therefore be irrelevant when such remuneration is furnished to a partner.

Compensation payments by an S corporation to shareholder employees, on the other hand, *are* considered wages for FICA purposes.[242] Section 1372, which makes the statutory fringe benefit rules of S corporations follow those of partnerships, applies only to Subtitle A of the Code, which does not include the employment tax provisions.[243] Therefore, it seems that meals and lodging furnished by a farm S corporation to its shareholder employees and family members would be exempt from FICA tax even though the same expenses may not be deductible by the corporation by reason of section 280A or excludible from income by the employees because of section 1372(a).

B. Medical Benefits

A variety of fringe benefits furnished by employers to employees have traditionally qualified for tax advantages, usually because they are deductible by the employer but not includible in the income of the employee. Among the most popular of the benefits available where an employer-employee relationship exists is the provision by the employer of health insurance and other types of medical benefits for the employee and his or her family.

Most of the same benefits have been available to share-

241. Treas. Reg. § 1.707-1(c); *see* Treas. Reg. § 1.1402(a)-1(b).
242. Rev. Rul. 73-361, 1973-2 C.B. 331.
243. I.R.C. § 1372(a).

holders in regular corporations, now C corporations. A shareholder employed by his or her corporation is considered an employee, and the corporation is the employer for most purposes. On the other hand, a self-employed person, such as a sole proprietor, may not deduct premiums for medical insurance coverage for himself or herself and family.[244] Such premiums and other medical expenses are deductible, if at all, only as provided in section 213. Under section 213(a), such expenses are deductible only to the extent that they exceed 5% of the taxpayer's adjusted gross income. Since the deduction provided by section 213 is an itemized deduction,[245] the usefulness of even the expenses which exceed the 5% threshold is limited by the fact that they are deductible only to the extent they exceed the zero bracket amount.[246] The zero bracket amount is $3400 for a proprietor filing a joint return with his or her spouse.[247]

There are, however, additional considerations if the proprietor's spouse is a bona fide employee of the proprietor. The cost of an accident and health plan provided by an employer to an employee is normally deductible under section 162(a).[248] On the other hand, a bona fide employee generally does not include the employer-paid medical insurance premiums into income,[249] even if the insurance covers not only the employee, but the employee's spouse and dependents as well.[250] The same may be true for certain medical expenses reimbursed by the employer.[251] It may be possible, therefore, for the proprietor to furnish medical insurance for the proprietor's family by simply covering the proprietor's employee-spouse and family—including the proprietor spouse. Where a true employer-employee relationship exists

244. Treas. Reg. § 1.105-5(b); Rev. Rul. 58-90, 1958-1 C.B. 88; Smith v. Commissioner, T.C. Memo 1980-523, 41 T.C.M. 425, 427 (1980).

245. *See* I.R.C. § 63(f).

246. I.R.C. § 63(b), (c).

247. I.R.C. § 63(d)(1).

248. *See* Treas. Reg. § 1.162-10(a); *see also* Letter Ruling 10-26-43, ¶ 66,326, 1943 Fed. Tax (P-H); Rev. Rul. 56-632, 1956-2 C.B. 101.

249. I.R.C. § 106.

250. Treas. Reg. § 1.106-1.

251. I.R.C. § 105(b); Treas. Reg. § 1.105-2.

with respect to that spouse, the insurance premiums should be deductible by the proprietor and excludible by the employee-spouse to the same extent as if furnished to an unrelated employee. Such coverage would no doubt be closely scrutinized by the IRS, as are the basic wage payments to the employee-spouse.

The same could be true of a medical expense reimbursement plan adopted in conformance with the rules of section 105. However, section 105(h) applies restrictive rules with respect to a "discriminatory self-insured medical expense reimbursement plan." These restrictions might limit or eliminate the advantage of the plan to the proprietor and his family. However, the restrictive rules do not apply to reimbursements to employees for premiums on health insurance coverage.[252]

In the case of a partnership, the cost of medical benefits provided for a partner is not deductible.[253] The same is true with respect to benefits provided to a "2-percent shareholder" by an S corporation.[254] On the other hand, benefits provided by an S corporation to one who is not a "2-percent shareholder" or by a partnership to a nonpartner employee would generally be deductible. If the nonpartner employee were a spouse of one of the partners, the same indirect coverage might be effected as discussed above in connection with proprietorships. In the case of the S corporation, this would not be available, since an employee spouse who does not actually own stock in the corporation is nevertheless *deemed* to own the stock owned by his or her spouse.[255] Thus, if the shareholder spouse was an actual 2-percent shareholder, the employee spouse would be deemed to be so. The result under section 1372(a) is that both the shareholder-employee and the employee spouse would be treated in the same manner as partners, and the expenses would be nondeductible by the corporation.[256]

252. Treas. Reg. § 1.105-11(b)(2).
253. I.R.C. § 703(a)(2)(E).
254. I.R.C. § 1363(b)(2). *See* H.R. REP. NO. 826, 97th Cong., 2d Sess. 21 (1982).
255. I.R.C. § 318(a)(1).
256. *See supra* note 254.

VII. CONCLUSION

This article is not intended to serve as a definitive study of compensation arrangements. Its purpose is simply to review some of the more likely compensation concerns and opportunities in various types of family agricultural enterprises. It is unlikely that the concerns and/or opportunities discussed will lead to a major restructuring of a present business operation. In fact, many of the opportunities are mutually exclusive in the sense that a particular form of business operation will be conducive to some but will bar others. For example, a farmer who incorporates in order to pay his or her spouse wages which will qualify for the two-earner spouse deduction under section 221 should consider that the exemption from FICA taxes for those wages will thereby be lost.

Likewise, paying wages to the operator's children for the reasons which have been discussed will usually be appropriate only where the children are already actively involved in the family business. The same is true of compensating the operator's spouse. Bringing these family members into active operation of the business solely for the potential tax benefits might lead to a loss of efficiency if more skilled employees are thereby displaced.

The suggestion, then, is to analyze the present business operation to determine whether any of the tax planning opportunities which have been discussed are available without the necessity of a major change in either the form or substance of the business. Where the children are already actively involved in the business, for example, the tax advantages available if they are reasonably compensated may be secured with little disruption of the present operation. The same may be true of payments to a spouse who is already contributing his or her efforts to the family business. If the business is already incorporated and the family is living on the farm, it certainly may be worthwhile to consider whether the nature of the business is such to support the provision of meals and lodging to the family employees in the tax-advantaged manner which has been discussed.

Finally, it is important to keep in mind that tax plan-

ning, by its very nature, requires constant review and reevaluation. This need has been accentuated in recent years by several pieces of major tax legislation. Digesting and evaluating these changes will likely continue at least until the next legislative enactment makes them irrelevant. Any planning steps taken in the compensation area will therefore likely require further refinement and adjustment in the future as administrative, judicial and legislative developments occur.