Roob v. Commissioner, 47 T. C. 900 (1967)

The court clarified the criteria for determining reasonable compensation in Subchapter S corporations and the tax treatment of payments received under franchise agreements.

Summary

In Roob v. Commissioner, the court addressed two main issues: the reasonableness of compensation paid to a shareholder-employee of a Subchapter S corporation and the tax treatment of a $1,000 payment received under a purported franchise agreement. The IRS had reallocated dividends among shareholders to reflect higher compensation for Walter Roob, a shareholder who rendered significant services to the corporation. The court upheld this reallocation, finding insufficient evidence to prove the compensation was reasonable. Additionally, the court ruled that the $1,000 payment was ordinary income, not capital gain, as it was not a sale of a franchise but rather payment for services.

Facts

Walter and Mary Roob operated a photography studio as a partnership before incorporating it as Roob Studio, Inc. , a Subchapter S corporation. Walter received a salary of $10,000 in 1962 and $12,000 in 1963 and 1964. The IRS determined that Walter's reasonable compensation should be higher and reallocated dividends accordingly. In 1964, Roob Studio received $1,000 from Donald and Marilyn Wick under a "franchise agreement" related to the Family Record Plan, which the studio reported as capital gain. The IRS treated this payment as ordinary income.

Procedural History

The IRS issued a notice of deficiency to the Roobs, reallocating dividends and treating the $1,000 payment as ordinary income. The case was heard by the Tax Court, which consolidated the cases of Walter and Mary Roob for decision.

Issue(s)

1. Whether the IRS correctly reallocated dividends among shareholders of Roob Studio, Inc. , to reflect the value of services rendered by Walter Roob?
2. Whether the $1,000 received by Roob Studio, Inc. , under the "franchise agreement" should be treated as capital gain or ordinary income?

Holding

1. Yes, because the Roobs failed to prove by a preponderance of the evidence that Walter's compensation was reasonable, given the lack of reliable evidence on his role and contributions to the corporation's success.
2. No, because the "franchise agreement" did not constitute a sale of a franchise but

was a payment for services, making the $1,000 ordinary income rather than capital gain.

Court's Reasoning

The court applied the presumption of correctness to the IRS's determination, requiring the Roobs to prove otherwise. For the first issue, the court used criteria typically applied under Section 162(a)(1) for determining reasonable compensation, such as the nature of services, responsibilities, time spent, business size and complexity, economic conditions, and comparable compensation. The court found the Roobs' evidence, including unreliable statistical data from the Professional Photographers of America, insufficient to disprove the IRS's determination. For the second issue, the court examined the "franchise agreement" and found that Roob Studio retained extensive control over the operations, indicating it was not a sale but a contract for services. The court referenced Joe L. Schmitt, Jr. , and Theodore E. Moberg, emphasizing that the retained control was inconsistent with a sale or exchange of property. The court concluded that the $1,000 payment was ordinary income, not capital gain, as it was a prepayment for services.

Practical Implications

This decision underscores the importance of documenting and substantiating the reasonableness of compensation in Subchapter S corporations. Taxpayers must provide clear evidence of the employee's role and contributions to challenge IRS determinations. Additionally, the case highlights the need for careful structuring of franchise agreements to ensure they qualify for capital gains treatment. Practitioners should ensure that such agreements do not retain excessive control over the franchisee's operations. Subsequent cases, such as those involving similar compensation and franchise tax issues, have referenced Roob for guidance on these matters.

