La Mastro v. Commissioner, 72 T. C. 377 (1979)

The court held that pension plan contributions in a subchapter S corporation must be reasonable compensation for services rendered during the taxable year and cannot include compensation for pre-incorporation services or past undercompensation.

Summary

Anthony LaMastro, a dentist, formed a professional corporation that elected subchapter S status. During its 14-day initial taxable year, the corporation adopted a pension plan and contributed $24,000, which resulted in a net operating loss. The IRS challenged the deduction, arguing that it represented unreasonable compensation. The Tax Court, relying on Bianchi v. Commissioner, held that only $4,793 of the contribution was reasonable, limiting the net operating loss deduction to $6,589. 69. The decision emphasized that compensation must be based on services rendered in the current year and cannot account for past undercompensation or pre-incorporation services.

Facts

Anthony LaMastro, a dentist, incorporated A. M. LaMastro, D. D. S. , P. C. on November 20, 1970, and elected subchapter S status. The corporation's first taxable year was a 14-day period ending December 3, 1970. During this period, the corporation adopted a pension plan and made a $24,000 contribution to it, which was funded by a loan from LaMastro. The corporation's gross receipts were $5,462. 15, and total deductions, including the pension plan contribution, were $31,258. 84, resulting in a net operating loss of $25,796. 69. LaMastro claimed this loss on his personal tax return. The IRS disallowed a portion of the pension plan deduction, asserting it constituted unreasonable compensation.

Procedural History

The IRS issued a statutory notice of deficiency to LaMastro, disallowing the entire $24,000 pension plan contribution. LaMastro petitioned the Tax Court. The IRS later amended its answer, allowing a deduction of $4,793 of the contribution, asserting the remainder was unreasonable compensation. The Tax Court upheld the IRS's position, limiting the net operating loss deduction to $6,589. 69.

Issue(s)

1. Whether the $24,000 pension plan contribution made by the corporation during its initial 14-day taxable year constituted reasonable compensation for services rendered by LaMastro.

Holding

1. No, because the court found that only $4,793 of the contribution was reasonable compensation for services rendered during the 14-day period, limiting the net operating loss deduction to $6,589. 69.

Court's Reasoning

The court applied the rule from Bianchi v. Commissioner, which states that pension plan contributions are deductible only if they represent reasonable compensation for services rendered in the current taxable year. The court rejected LaMastro's argument that he should be allowed to deduct for past undercompensation or pre-incorporation services, emphasizing the separate taxable identities of different entities. The court determined that the best evidence of the value of LaMastro's services was the profit he derived from his practice, not comparative data or his capital investment in education. Given the corporation's brief operating period and low gross receipts, the court found the $24,000 contribution unreasonable, allowing only $4,793 as compensation for the services rendered during the 14 days.

Practical Implications

This decision clarifies that pension plan contributions in subchapter S corporations must be reasonable compensation for services rendered in the current year. Taxpayers cannot use such contributions to offset past undercompensation or pre-incorporation earnings. Practitioners should carefully assess the reasonableness of compensation in short taxable years, particularly when funded by loans from shareholders. This case may impact how professional corporations structure their compensation and retirement plans, ensuring they align with IRS guidelines on reasonable compensation. Subsequent cases like Bianchi have followed this precedent, reinforcing the principle in tax planning for professionals transitioning to corporate structures.