THE RELATIONSHIP OF CLIENT ADVOCACY AND CLIENT RISK ON OFFICER-SHAREHOLDER COMPENSATION RECOMMENDATIONS FOR S CORPORATIONS

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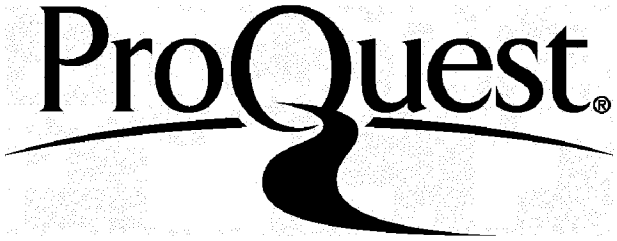
Submitted to the faculty of the Falls School of Business
in partial fulfillment of the requirements
for the degree

Doctor of Business Administration

Anderson University
Anderson, IN

November, 2016



Accepted by the DBA Program faculty, Falls School of Business, Anderson University
in partial fulfillment of the requirements for the degree
Doctor of Business Administration

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Date of Final Oral Examination: November 18, 2016

DEDICATION

I wish to dedicate this dissertation to my husband, Scott, and my son, Ethan. During this program, there were many hours spent reading, researching, traveling, and much resources spent, but having my family's support kept me going through this entire journey. My husband has always been there for me, and his constant encouragement and understanding were invaluable to me as I pursued this degree. Scott and Ethan mean the world to me and were my motivation always to finish the process. Pursuing a doctoral degree requires many sacrifices for the doctoral student, but my family also made sacrifices along the way for me to have this opportunity, and for that, I will be forever grateful. Thank you, Scott and Ethan, for motivating, encouraging, and inspiring me to fulfill this dream.

ACKNOWLEDGEMENTS

In addition to my husband and my son, my parents, Terry and Cathy, have supported me during every step of this process. I truly would not be the person I am today without their love, guidance, and encouragement. My parents have taught me many lessons along the way, and I would not be as successful as I am today without their constant prayer, encouragement, and support. Their sacrifices have allowed me to reach this dream, and for that, I am very grateful. Mom and Dad, I appreciate you both so much and appreciate all the time you have sacrificed to help me realize this dream!

To my in-laws, Robert and Connie, thank you for the support you have given me since I became a part of the family. The countless hours that you both have spent with Ethan so that I could research and write this dissertation have not gone unnoticed. Your willingness to help me in any way possible has meant so much to me. You both are an integral part of the reason I continued on this journey.

To my grandfather, the late Dr. Clyde W. Conger, M.D., who sponsored much of my college education. Grandpa, I am so thankful for your love for education and that you passed that passion on to me. You were a great example of someone pursuing a dream and obtaining a college education no matter the circumstance.

To the 2010 cohort of the Anderson University, Falls School of Business, Doctoral of Business Administration program, thank you for your support over the years. I am thankful for the relationships I gained out of this program, which continue to this day. Your willingness to help and your concern for all members of our cohort are unique and means so much to me. Through the many hours of coursework, research, and

writing, you were a constant force of inspiration and encouragement. I am truly blessed to have been a part of such an amazing cohort of people.

To my dissertation chair, Dr. Scott Miller, who taught me so much during the dissertation journey. Thank you for your enthusiasm and your constant encouragement during the many hours spent answering my questions and reading numerous drafts of my research. I truly appreciate it, and I am very thankful for your willingness to share your academic knowledge and wisdom with me. I am forever grateful for the sacrifices you made to be my dissertation committee chair. To my dissertation committee, Dr. Barry Ritchey and Dr. Leo Gabriel, thank you for the hours spent reading and offering feedback on my research. The sacrifices you made to be a part of my journey have not gone unnoticed.

To Dr. Doyle Lucas, Director of the DBA program, and to all the faculty of the Falls School of Business, thank you for the vision you held long ago to create a doctoral-level program whereby students could learn to research, teach, and grow in their faith. Your commitment to students is astounding and you have led by example since I first met all of you. I will be forever grateful that I was able to be a part of this program, and for the sincere interest you have shown to me, not only in my research and teaching, but also in my faith.

If it was not for these individuals, and many others, I would not have been able to complete this significant project, much less the program in its entirety. I thank God every day for allowing me this opportunity to be part of the Anderson University DBA program, and for providing me with purposeful relationships along this journey.

ABSTRACT

Laura J. Lachmiller

THE RELATIONSHIP OF CLIENT ADVOCACY AND CLIENT RISK ON OFFICER-SHAREHOLDER COMPENSATION RECOMMENDATIONS FOR S CORPORATIONS

The current US tax code is one that boasts complex rules and much ambiguity relating to certain tax positions. Determining reasonable compensation for an S corporation officer-shareholder is a relevant, ambiguous tax issue. Taxpayers are increasingly employing tax professionals, specifically when the taxpayer is faced with reporting an ambiguous tax issue. When making tax recommendations, tax professionals are bound by professional standards that assert the importance of advocacy on behalf of the client, while simultaneously advocating on behalf of the tax system. Characteristics of the client may also influence the recommendation a tax professional makes. Past research examined client advocacy and client risk in relation to a tax professional's recommendation regarding ambiguous tax issues (see Christensen & Hite, 1997; Cloyd & Spilker, 1999; Duncan et al., 1999; Hackenbrack & Nelson, 1996; Kadous & Magro, 2001; Kadous et al., 2008; Schisler, 1994; and Schisler, 1995).

This study hypothesized that the more advocacy the tax professional exhibits towards a client, the tax professional would make a more aggressive compensation recommendation for an S corporation officer-shareholder, while a tax professional would make a less aggressive compensation recommendation for an S corporation officer-shareholder that was perceived to be a high risk client. In an experimental study involving 210 tax professionals, this study did not find a link between client advocacy, client risk, and the compensation recommendation made by tax professionals. In

addition, this study did not find differences between demographic types of tax professionals regarding a compensation recommendation. The results of this study are inconsistent with prior research; therefore, additional research is needed to examine what concepts compel tax professionals when making S corporation compensation recommendations.

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Table of Contents

Chapter 1 – Introduction and Research Question

The United States' (U.S.) tax code is increasingly becoming more complex. Taxpayers, particularly those will little tax expertise, are more likely to hire tax professionals due to tax law complexity (Hite & McGill, 1992; Pei, Reckers, & Wyndelts, 1990). With this complexity comes ambiguous tax issues that are difficult to resolve, and tax professionals, because of their specialized expertise and knowledge, provide guidance and recommendations about these types of tax issues (DeZoort, Harrison, & Schnee, 2012). As a result, tax professionals can have influence over taxpayers' aggressive/conservative propensities (Pei et al., 1990). Furthermore, fines, penalties, and other sanctions have been established by the Internal Revenue Service (IRS) and Congress, given the recognition of the important role that tax preparers possess in tax compliance due to their advocacy function (Duncan, LaRue, & Reckers, 1989).

S corporations often present complex tax issues for tax professionals (Jackson & Milliron, 1989). One such issue is that of S corporation officer-shareholder compensation determination. Salaries are required for officer-shareholders, but there is not an absolute definition given by the Internal Revenue Service (IRS) for reasonable compensation. Rather, defining reasonable compensation is situational in nature and not a question of exact law (Fellows & Jewell, 2006). This issue presents a unique opportunity for taxpayers that are officer-shareholders of S corporations to avoid certain payroll taxes, but the IRS is currently intensifying its scrutiny of this matter through tax return audits, for which no S corporation will be immune (Antognini, 2003; Fellows & Jewell, 2006; Fellows & Jewell, 2007).

According to the American Institute of Certified Public Accountants (AICPA), tax professionals must act as advocates for their clients within legal boundaries. Furthermore, AICPA standards also specify that tax professionals are also advocates for the tax system. Because a tax professional is to advocate for both parties, it is not always possible for them to satisfy both requirements.

In addition to the advocacy role, tax professionals must also evaluate all relevant tax authorities and facts in an objective manner when making recommendations. When making these recommendations, tax professionals are exposed to certain client-based risk factors that may hinder them from evaluating information objectively and ultimately fulfilling the advocacy role (Kadous & Magro, 2001). Client-based characteristics that have been identified as risk factors to tax professionals include client uncooperativeness, fee pressures, litigation involvement, suspicious transaction recommendations, and weak records (see Bandy, 1996; Fiore, 1998; Kadous & Magro, 2001). Thus, a focal point of a tax professional's advocacy role is that of client risk. Client risk is defined as the costs, both monetary and nonmonetary,[1] to a tax professional for inappropriate tax recommendations, and it varies based on identified client characteristics and associated client risks. The risk a client portrays has influence over the advocacy a tax professional is willing to provide for that client. This study seeks to investigate whether this advocacy role and client risk play a role in tax professionals' recommendations of S corporation salary determination.

[1] The costs associated with making an erroneous recommendation are both monetary and nonmonetary for the tax professional. Examples of monetary costs include legal fees, preparer penalties, and additional amounts owed to the client due to interest and penalties. Examples of nonmonetary costs include exposure to malpractice litigation, damages to reputation, sanctions imposed by professional organizations and accountancy boards, and emotional burdens associated with criticism of work. See Bandy (1996), Boyles and Feldman (1988), Ferguson (1996), Fiore (1998), Hill (1998), Kadous and Magro (2001), and Schaefer and Zimmer (1997) for a more detailed discussion of the costs associated with client risk.

The concept of a reasonable wage for officer-shareholders of S corporations is a timely and relevant issue that the IRS has focused on recently. There has been some guidance issued from the IRS regarding this issue, but there is no set compensation formula to determine the amount for these shareholders because of the many factors that would indicate what a reasonable wage could be; therefore, compensation calculations many times are influenced by the professional judgment of a tax professional, because there are numerous tax considerations when establishing characterization of payments as compensation or distributions to officer-shareholders (Fiore, 1990). Therefore, the research question posed in this study is to examine the relationship of client risk, the risk a tax professional bears from drawing an erroneous conclusion, and client advocacy,[2] which represents the advocacy for favorable tax positions that tax professionals provide taxpayers, to a tax preparer's recommendation of the compensation of an officer-shareholder of an S corporation. This study will also seek to examine the magnitude of the relationship between client advocacy, client risk, and compensation recommendations.

The importance of this study stems from the timeliness and relevance in the tax industry. Currently, the IRS is intensifying their pursuit of S corporation officer-shareholders who take distributions and do not take any wages or reasonable wages from their companies that have profitable operations (net income). This pursuit is evidenced by the number of recent court cases involving S corporations and the IRS (see *Radtke v.*

[2] Client advocacy is defined as the state of mind where the tax professional believes that loyalty belongs to the taxpayer, by demonstrating a passionate desire to represent the taxpayer and fight on behalf of the taxpayer within legal boundaries (Mason & Levy, 2001; see also AICPA, 2010).

United States, 1989/1990; *Spicer Accounting v. United States*, 1990; *Yeagle Drywall Co*, 2001; and *Joseph M. Grey v. Commissioner*, 2002/2004).

S corporations many times will seek the assistance of a professional tax preparer to help determine a reasonable wage for its shareholders. This is an ambiguous issue in the tax code since there is only limited guidance and no particular definition of what constitutes reasonable officer-shareholder compensation, and one that warrants further study. Ambiguity is simply defined as "uncertainty about uncertainty" (Helleloid, 1989, p. 25). Reasonable compensation for officer-shareholders is ambiguous since it is a line item on the tax return for which there is considerable ranges in calculating actual monetary values (Klepper & Nagin, 1989).

It is also a relevant topic, given the tax implications that individuals will face as new taxes are imposed as a result of the healthcare bill, the Patient Protection and Affordable Care Act (ACA). To finance health care reform, new taxes have been implemented, many of which began in 2013 (Schreiber & Nevius, 2012). One new such tax is the additional Medicare tax on investment income, which imposes an additional 3.8% Medicare tax on either the individual's net investment income or the amount of the individual's modified adjusted gross income (MAGI) that is greater than a threshold, whichever is the lesser of the two (Schreiber & Nevius). In addition, the law increases the employee Medicare tax portion of FICA by an additional 0.9% for incomes over a certain threshold (Schreiber & Nevius). For taxpayers that meet these thresholds, income will be taxed at increased levels. Many small businesses will work to find ways to minimize these additional tax burdens. Electing S corporation status may be one such avenue to avoid these additional payroll taxes if distributions are classified as a return of

investment rather than compensation (Johnson, 2012). Therefore, it is important that both taxpayers and tax professionals are educated about S corporation requirements and awareness is raised about the consequences of reporting little or no compensation for closely-held S corporations (Antognini, 2003).

This topic is also relevant because of the potential impact on preparer penalties. Research has shown that increased preparer penalties have impacted the tax preparer's role as advocate, but has not diminished a tax preparer's aggressive advice and tax position recommendations (Ayres et al, 1989; Cuccia, 1994). Furthermore, in light of these tax preparer penalties and the courts' support of the IRS on this issue, taxpayers and their tax practitioners still seek to escape officer-shareholder compensation and the related taxes, despite the cost both to tax practitioners and taxpayers[3] (Bobek, Hatfield, & Kramer, 2004; Fellows & Jewell, 2006; Fellows & Jewell, 2007).

This study will also provide additional evidence regarding ambiguous tax scenarios in the behavioral taxation literature. It will also assist in providing further direction concerning training and educating tax professionals of the importance of their roles as advocates within the tax decision-making process. When officer-shareholders do not take compensation from the S corporation, there is a loss of revenue to the IRS (Fellows & Jewell, 2007). In a report from the Treasury Inspector General for Tax Administration (TIGTA), it was estimated that almost $6 billion was lost in tax revenue due to compensation not being paid to officer-shareholders in tax year 2000 (Gardiner, 2005). Tax practitioners must be aware of this while advocating for both the taxpayer

[3] Sec. 530 of the Revenue Act of 1978 provides for a safe harbor for taxpayers if mistaken about a worker's classification. Sec. 530 provides that a taxpayer can have relief of liability for not following employment tax rules found in I.R.C. §6651 and I.R.C. §6656, but only if the taxpayer can establish that there was a reasonable basis for the misclassification.

and the tax system, as admonished by the AICPA. As a result, this study is timely for tax practitioners in gaining a better understanding of their role as advocate for ambiguous tax cases.

Research Contributions and Limitations

The intent of this study is to contribute to the literature regarding tax professional behaviors for ambiguous tax research issues. As outlined in the description of the research methodology, a survey will be conducted to gather data regarding a tax professional's recommendations concerning the amount of compensation for an S corporation officer-shareholder. In addition, regression analysis will be utilized to test the significance of the relationships between a compensation recommendation and client advocacy and client risk.

This research focuses on a relevant and ambiguous tax issue regarding tax professionals' recommendations: what constitutes a reasonable compensation for S corporation officer-shareholders? This study will add additional research designed around an ambiguous tax issue not found in previous studies. Bobek et al. (2010) conducted a study to examine the influence on client advocacy and client risk for a different ambiguous tax issue, but no research is known that studies these variables for S corporation compensation. Furthermore, the results of this study will contribute to the behavioral tax literature by testing client characteristics of client advocacy and client risk on tax recommendations for which there is no clear guidance.

The results of this study will contribute to the greater knowledge of tax professionals' recommendations in an uncertain taxation area. If the results show statistical significance or not, the research will give insight to whether client advocacy,

client risk, or both will have an impact on tax professionals' recommendations in this particular ambiguous tax scenario. This is important since it has been suggested that tax professionals are more likely to research and cite authoritative sources that are consistent with a client's preference (Cloyd & Spilker, 2000). The results of this study could then provide for increased training that may assist tax professionals in recognizing this type of research bias in uncertain tax issues.[4]

This research intends to ask tax professionals from a state society of Certified Public Accountants (CPAs) to participate in this study. Consequently, a limitation of this research will be that the results may not be generalizable to the body of tax professionals in the United States (U.S.). Also, this study will only employ one ambiguous tax research issue. To mitigate this limitation, a common ambiguous tax research issue will be relied upon for the survey (Bobek, Hageman, & Hatfield, 2010). This is a common ambiguous tax research issue since there is not an absolute definition for what constitutes reasonable S corporation officer-shareholder compensation, but only limited guidance on the issue is available.

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[4] In this study, the term "ambiguous tax issues" is synonymous with "uncertain tax issues". According to Helleloid (1989), an issue that is uncertain is considered to be ambiguous. Uncertain tax issues then are uncertain simply due to a level of ambiguity surrounding them. Moreover, uncertain tax issues are different from uncertain tax positions, which require filing an Uncertain Tax Position Statement (also known as IRS Schedule UTP) to be filed for certain corporations. Accounting income is calculated based on Generally Accepted Accounting Principles (GAAP), while taxable income is calculated using the Internal Revenue Code (IRC). At times, there are differences between the reported accounting income and taxable income for a business, and a business may be required to include a reserve for the difference in the financial statements according to Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48). Some of these differences are permanent, since these differences will never be fully realized, such as IRC credits, exemptions, and exclusions (Hennig, Raabe, & Everett, 2008). These permanent differences cause a reduction then in a business's reported effective tax rate (Hennig et al.). If a tax position taken is uncertain, which is defined as "those material items not fully certain by the taxpayer to be sustainable on a later review based on their technical merits" (Hennig et al., 2008, p.27), then it will be reported on IRS Schedule UTP (Hennig, Mautz, & Evans, 2013). The issue of reasonable compensation for S corporation officer-shareholders is an uncertain tax issue, not an uncertain tax position since it does not represent a difference between accounting income and taxable income as defined by both GAAP and the IRC.

Consistent with an experimental design, another limitation of this research is the connection between the participants' answers (intentions) and the hypothetical case scenario with that of actual behavior. However, the Theory of Planned Behavior helps to moderate this limitation. An individual's intentions and actual behavior have been found to be linked when control of the behavior is discerned by the individual (Ajzen, 1991).

The organization of the remainder of this paper will be in the following manner. Chapter 2 reviews the conceptual framework of client advocacy and client risk as it relates to taxation. In addition, it summarizes prior research on the usage of tax preparers in the United States (U.S.) and the features of electing S corporation status, including characteristics of such status, and reasonable compensation. Chapter 3 presents the research methodology, consisting of the aspects of data collection and descriptions of variables and relevant statistical methods. Chapter 4 presents the aggregate results and analysis of the data collected in this study. Lastly, Chapter 5 provides a summary of the findings of this research and presents conclusions, implications, and areas for future research.

Chapter 2 – Literature Review

According to the American Institute of Certified Public Accountants (CPA), tax professionals are expected to be advocates for their clients by assisting them in ensuring that they do not pay more taxes than what is legally owed (AICPA, 2010). Client risk also plays an important role in the advocacy attitudes of tax professionals. Client risk[5] represents the risk that tax professionals must bear due to erroneous recommendations (Bobek et al., 2010; Kadous & Magro, 2001). Together, these attitudes have been shown to influence tax preparer recommendations.

In a study performed by Bobek et al. (2010), perceptions of client risk were found to have influenced client-specific advocacy. Ultimately, client-specific advocacy then prompted the tax preparer's recommendations for an ambiguous (uncertain) tax issue. Their study suggested that client characteristics (such as client risk) were the motivation for a tax professional's attitude towards client advocacy, and ultimately, the tax preparer's recommendations. Their study supports this model of client risk and client advocacy (see Figure 1):

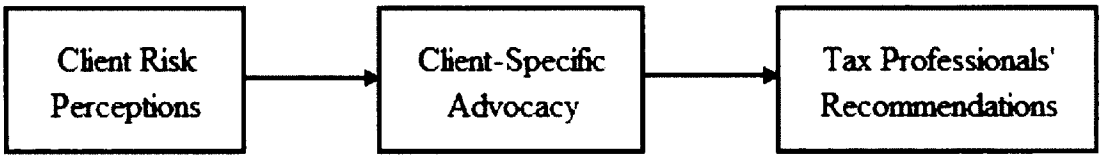

Figure 1. Client risk and client advocacy model.

[5] In the literature, client risk is also referred to as practice risk. In a study performed by Kadous and Magro (2001), the term "practice risk" is used to describe the construct of risk from erroneous recommendations that tax professionals must bear. In a more recent study, Bobek et al. (2010) use the term "client risk" to describe this construct. This study will use the term "client risk" when referencing this construct.

This model will be used in the current study and applied to the ambiguous tax issue of recommending a reasonable compensation amount for S corporation officer-shareholders.

Prior Research

Under the current tax code in the United States (U.S.), a taxpayer is not obligated to pay taxes beyond those that are legally owed. Tax avoidance is the practice of minimizing tax liabilities to the extent allowable within the bounds of the tax law, while tax evasion is the practice of illegally minimizing tax liabilities. However, as complexity of the tax code increases, the boundaries of what constitutes tax avoidance and tax evasion are blurred (Duncan et al., 1989). Because of complexity and lack of expertise by taxpayers, recommendations and guidance on ambiguous tax issues originate from tax professionals (Duncan et al.).

Tax professionals serve as advocates for their clients. Because of this advocacy role, it has been expected that a Certified Public Accountant (CPA) and other tax professionals propose the best possible tax position for an ambiguous issue within the legal boundaries of the law for the clients (Duncan et al., 1989). These recommendations may be influenced from preferences by the clients themselves, such as the result of less aggressive advice from a tax preparer when the client is risk averse (Duncan et al.).

Tax professionals serve clients by resolving tax issues, namely ambiguous issues. One such ambiguous issue that tax professionals provide guidance about is S corporation officer-shareholder salary determination. S corporation taxable income is not subject to self-employment taxes on a shareholder's individual tax return. Since this is not the case for partnerships and Limited Liability Companies (LLCs) taxed as partnerships, the treatment of distributions in lieu of compensation for S corporation officer-shareholders

can be problematic and often be situations in which CPAs can offer beneficial recommendations (Ledgerwood, 2010). However, tax professionals must be cognizant of certain consequences for being too aggressive in their advice. One such consequence is that of liability. Because the tax profession is a service-oriented profession, liability claims provide a significant concern for most tax professionals (Bobek, et al., 2004). Another consequence is that faced by the taxpayers for not properly classifying payments to officer-shareholders. If payments are reclassified by an audit, taxpayers will ultimately be faced with larger employment tax liabilities, which will most likely include interest and penalties (Fellows & Jewell, 2007). Therefore, tax professionals must exercise judgment while also advocating for their clients when they make tax position recommendations.

Subchapter C and Subchapter S in the Internal Revenue Code

Business entity taxation involves two types: taxable corporations (which are governed by Subchapter C of the Internal Revenue Code) and pass-through entities, such as partnerships and S corporations (Wilkie et al., 1996). Since the passage of the Tax Reform Act of 1986, there has been a consistent shifting of business entities away from the corporate form and toward the pass-through form (Plesko, 1994; Plesko & Toder, 2013; Wilkie et al.). Taxation of corporations is generally governed by the rules set forth in Subchapter C of the Internal Revenue Code (IRC), but an entity may elect to be taxed as an S corporation. When this election is made, some of the rules of Subchapter C apply as well as the requirements set forth in Subchapter S, which govern S corporations. If Subchapter S does not provide alternative taxation rules, the S corporation is bound by the requirements set forth in Subchapter C. For example, taxable corporations (C

corporations) are required to apply the calculation of corporate tax found in IRC Sec. 11, while Subchapter S nullifies this for the S corporation. As a result of electing S corporation status, an entity has benefits from other business forms (Calcagni, 2010; Sefransky & Brinker, 2007). An S corporation has the limited liability and capital raising ability associated with a corporation, while having some of the tax aspects and the pass-through rules of partnerships (Sefransky & Brinker, 2007).

Congress created the S corporation status in 1958 to spur economic growth through small businesses (Denis & Sarin, 2002; Plesko, 1994). Subchapter S (Sections 1361-1379) of the IRC governs the requirements an entity must meet for eligibility in electing to be taxed as an S corporation. For a qualifying corporation whose shareholders have consented, the election is made on Form 2553 according to IRC Sec. 1362 (a). In order for an entity to elect S corporation status, the entity must be a "small business corporation" (IRC, Sec. 1361).

IRC Sec. 1361 defines a small business corporation as a domestic corporation that has met four specific criteria. These criteria impose certain capital and shareholder limitations. The requirements are that the entity have no more than 100 shareholders; only individuals, estates, and trusts as shareholders;[6] shareholders that are not nonresident aliens in the United States (U.S.); and only one class of stock.[7] Shareholders that are members of the same family are treated as one shareholder.[8] For the stock to classify as

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[6] Based on IRC Sec. 1361, corporations (except for a tax-exempt charity), partnerships, or LLCs (whether taxed as a corporation or partnership) not are qualifying shareholders.

[7] To classify as having one class of stock, the entity's stock must have identical rights for all shareholders regarding distributions and liquidations (McMahon & Simmons, 2014). In Sec. 1361(c)(4), however, voting rights can be different as long as the rights are identical for all shareholders regarding profits and the corporation's assets (see McMahon & Simmons).

[8] In IRC Sec. 1361, there is imposed on an entity electing S corporation status certain capital and shareholder limitations. As referenced, S corporations cannot have more than 100 shareholders. However, this is somewhat misleading, since shareholders that are members of the same family are treated as one

one class of stock, the entity's stock must have identical rights for all shareholders regarding distributions and liquidations (McMahon & Simmons, 2014).

Establishing the concept of reasonable compensation.

When determining the reasonableness of compensation paid to taxable corporation owners, IRC Sec. 162 provides two tests for determining the deductibility of such payments: the compensation payments must be reasonable and for services actually performed. Both criterion of this code section must be satisfied in order for compensation payments to be deductible, but the service test must be proven first, showing the intention of the payment (Bertozzi, 1978). If the intent of such a payment cannot be established, then the second test, whether it is reasonable or not, is not necessary. However, the construct "reasonable" is not defined in the IRC or Treasury Regulations, nor are any criteria set forth to determine what represents reasonable compensation; it is the courts that have largely navigated what constitutes reasonable compensation (Porcano, 1982).

As with other types of deductions, the IRC requires that payments of compensation to corporate owners be reasonable, or what the market rate for compensation would be for an unrelated party (Geisler & Wallace, 2005). Both C corporations and S corporations are bound by the construct of what is reasonable when determining compensation to officer-shareholders (Panitz, 2009). Nevertheless, the concept of reasonableness differs with C corporations and S corporations. For C corporations, reasonableness is investigated as to an amount, as amounts may be called

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shareholder. IRC Sec. 1361(c)(1) provides the definition of what constitutes a family member. A family member is considered any individual that is part of a family's common ancestry, but not more than 6 generations removed.

into question for being too high,[9] while reasonableness for S corporations is generally scrutinized regarding if the corporation paid compensation or not[10] (Kirkland, 2013a). Furthermore, reasonableness is not determined by how large or small an amount is, but whether it is reasonable within the applicable context (Panitz).

Even though the construct of reasonableness is slightly different for C corporations and S corporations, the consequences are generally the same. For both forms, if compensation is determined to be unreasonable, reclassification of the payments occurs. If the Internal Revenue Service (IRS) deems a compensation payment to be unreasonable to the taxable corporation's owner, the payment is reclassified as a constructive dividend. For taxable corporations, dividend payments are not a business deduction. Therefore, this creates a problem for the taxable corporation, because it loses the deductibility of the compensation reclassified as a dividend. Despite the risk of reclassification of compensation, compensation packages still remain more flexible and a potentially larger deduction than interest or rent for payments to corporate owners (Geisler & Wallace).

The court system has been largely involved in determining reasonable compensation. Reasonableness has been established using a variety of tests in the courts, from the use of the five factors introduced in the case, *Elliotts Inc., v. Comm'r* (1983), to the independent investor approach based on the Return on Equity calculation (ROE), introduced in the case, *Exacto Spring Corp v. Commissioner* (1999) (see *Elliotts, Inc, v. Comm'r*, 1983; *Exacto Spring Corp v. Commissioner*, 1999). The investor approach can

[9] Compensation amounts may be high in C corporations in an effort to reduce the impact of double taxation and move income to the owners. This is discussed in detail below.
[10] Compensation amounts for S corporations may be low or not paid at all for the purpose of reducing payroll taxes to the corporation, and ultimately, increasing the value of corporation to the owner.

be a practical tool that CPAs and tax advisors can use since the calculations are somewhat simple and are normally understood by corporate taxpayers (Panitz, 2009). Ultimately, because of these tests, reasonableness is established in the courts using each case's individual facts (Bertozzi, 1978; Nash & Quinn, 2006).

The courts have introduced the five-factor test in determining reasonableness through the case, *Elliotts, Inc., v. Comm'r* (1983). To establish reasonableness for officer-shareholder compensation, these five factors were used in the case: (1) examination of the employee's role within in the company, (2) external comparison of the salary paid with other similar employees and corporations,[11] (3) analysis of the company's current character and condition, (4) scrutiny of possible conflicts of interest by using (ROE), and (5) consideration of whether there was a constituent internal compensation program. These five factors have become known as the *Elliotts* factors and have been used in a number of cases to establish reasonableness for compensation (see *Rapco, Inc., v. Comm'r*, 1996; *E. J. Harrison & Sons, Inc., v. Comm'r*, 2003; *Multi-Pak Corp v. Commissioner*, 2010).

The issue at hand for the *Elliotts* case was whether compensation payments made to the sole shareholder of the corporation were reasonable or whether they represented disguised dividend payments for tax years 1975 and 1976. Compensation for Edward G. Elliott, sole shareholder of Elliotts, Inc., had a fixed and variable component. The shareholder received a fixed salary of $2,000 a month, but the year-end bonus paid was a percentage of net profits. For the 1975 and 1976 tax years, the IRS allowed

[11] This factor has been relied on quite frequently by the courts (Bertozzi, 1978), and is specifically stated in the Treasury Regulations as being a criteria for establishing reasonableness [see Treas. Reg. §1.162-7(a)]. The other factors have come from the abundance of case law regarding corporate reasonable compensation [see Bertozzi (1978) for a review of some of these cases].

approximately 35% and 34%, respectively, of the payments to be deductible compensation. In the end, the Court allowed approximately 67% and 65% of the payments to Elliott to be classified as compensation for tax years 1975 and 1976, respectively. Ultimately, this court case also contributed the standard of establishing reasonableness by examining issues from a hypothetical investor's perception.

In the *Rapco* (1996) case, the IRS had determined that the compensation paid to Richard Polidori was unreasonable for tax years1988-1990, and so portions of the payments were disallowed and reclassified as dividends. Polidori's salary had increased during these tax years, but the company had also experienced growth during this time. However, the IRS established that the payments were still unreasonable even in comparison to the company's current growth. When the matter was taken to the Tax Court, the Court used the *Elliotts* factors to establish reasonableness, and determined that the IRS' allowed compensation amount was too low. Interestingly, in this case, some of the factors were in the taxpayer's favor, but some of them were not. In the end, it was these factors that led the court to still disallow some of the compensation for those tax years.

E.J. Harrison & Sons, Inc., v. Comm'r (2003) was somewhat similar to previous cases. The corporation was a waste management company and was family-owned. In this case, all officers received compensation, but one of the officer's compensation was called into question when it was compared to the other three officers' compensation and their roles within the corporation. The president's salary was much higher than those of the three vice presidents. In addition, the corporation had never paid a dividend, which heightened the scrutiny of the compensation arrangements, especially those for the

president of the company. Using the *Elliotts* factors, it was determined that the president's salary was unreasonable and that some of the payments were in fact dividends. Again, the courts allowed in this case a higher allowed amount than what the IRS was allowing, but it was substantially lower than what was originally paid out as compensation.

For *Multi-Pak Corp v. Commissioner* (2010), the *Elliotts* factors were again used to establish reasonable compensation for the company's sole shareholder. Interestingly, this was also a case where some of the *Elliotts* factors were in the taxpayer's favor. What caused a reclassification of compensation for one of the tax years in question was when the facts of the case were examined considering a hypothetical investor. Ultimately, because of the return on equity (ROE) assessment and the favorable application of the factors, the courts allowed the full compensation amount for tax year 2002, but allowed approximately 62% of the payments in 2003 to be classified as compensation. Moreover, the court also agreed with the taxpayer that penalties should not be assessed since the taxpayer had relied in good faith upon professional advice from its CPA and tax consultant.

Using ROE as a foundation for determining reasonable compensation is highlighted by the case, *Exacto Spring Corp v. Commissioner* (1999). For this case, the appellate court ruled that the factors used by the Tax Court in establishing reasonable compensation were erroneous since it did not give any weighting to the factors. Rather, the appellate court held that the better test in this case was the investor approach, which allowed the corporation to fully deduct the compensation payments in question since

there was such inconsistency applied to the case facts when the Tax Court used other factors to determine reasonableness.

Another court case that used the investor approach to determine reasonable compensation was *Automotive Investment Development Inc. v. Commissioner* (1993). In this case, the courts determined that the outstanding return on equity (ROE) was enough to justify the compensation paid to the shareholder-manager, even though no dividends had been paid, for the three tax years in question. It was determined that a hypothetical investor would have been satisfied with the results of ROE, and thus, no conflict of interest would exist. In addition, the company's bonus plan for the shareholder-manager was similar with other plans in the automotive industry at that time.

Interestingly, there was a court case that found compensation to the corporation's CEO and controlling shareholder to be unreasonable even though the independent investor test was met. In *Menard, Inc. v. Commissioner* (2004), the courts found that the CEO's compensation, which included a base salary, a profit-sharing plan, and a bonus, was reasonable when the independent investor test was applied. However, this test was negated when the compensation was compared to other CEOs in the home improvement store industry, as stated in Treasury Regulation §1.162-7(b)(3). This case illustrates that even though compensation was deemed reasonable through one test, other factors were taken into account, and in this instance, were given more weight than the one test.

Remarkably, there was a court case in 2005 that used the independent investor test and some of the *Elliotts* factors to determine that compensation paid to three officer-shareholders was in fact reasonable. In *Miller & Sons Drywall, Inc. v. Commissioner* (2005), three brothers that were officer-shareholders and employees of a drywall

corporation were paid salaries and a bonus each fiscal year as total compensation for the services they rendered to the company. The IRS disallowed the compensation amounts for all three officer-shareholders for the tax years 1998 – 2000. However, when the matter was taken before the Tax Court, the Tax Court allowed the full amounts of compensation to be deductible on the corporation's tax return. The Court used the independent investor approach and a variety of other factors, including comparison of the compensation to other external companies in a similar industry and the written policy of the corporation regarding all employees, to render its decision. In the end, it was the officer-shareholders' knowledge and experience, their direct relation to the success of the corporation, the methods used to calculate the compensation, and favorable ROE that led to the decision that the compensation was reasonable by the Court.

C corporation compensation

For decades, the issue of what is reasonable compensation has been one of the most challenged between the IRS and taxpayers (Porcano, 1982). Currently, what constitutes reasonable compensation is a complicated issue for both closely-held C corporations and S corporations (Kirkland, 2013a). Even though the determinants for compensation are somewhat distinctive and identified in the Code – unreasonable compensation is investigated in C corporations and S corporations are investigated to ensure they have reasonable compensation for officer-shareholders - organizations operating as either have been under close scrutiny by the IRS in recent years (Kirkland, 2013a). Compensation payments represent a business deduction for both C corporations and S corporations. However, compensation arrangements have different tax effects when comparing C corporations and S corporations. For C corporations, compensation represents a tax

deduction to lower taxable income, while compensation represents increased employment taxes, most notably, Social Security and Medicare, for S corporation owners. Taxable C corporations are more likely to engage in compensation as a deductible payment, while S corporations do not use compensation as a mechanism for reducing entity-level income through deductible payments (Ayers, Cloyd, & Robinson, 1996). Thus, research indicates that C corporations will use compensation in alleviating increases in corporate taxable income more so than S corporations (Geisler & Wallace, 2005). It is then important to examine the issue of reasonable compensation for C corporations from the Code Sec. that governs business deductions and executive compensation.

According to IRC Sec. 162(a)(1), business deductions must be "ordinary and necessary, including a reasonable allowance for salaries or other compensation for personal services actually rendered." This portion of the code has remained largely unchanged since it was introduced in the Revenue Act of 1918[12] (Bertozzi, 1978). Compensation has been used as a tax avoidance mechanism for C corporations since compensation is a business deduction that can lower taxable income for these taxable corporations. If compensation is especially high, the IRS will examine if the compensation was used to distribute corporate profits or if the compensation was even related to services rendered (Nash & Quinn, 2006). It is a potentially risky tax area for corporations since the IRS may not allow all compensation payments for top executives to be deductible business expenses (Panitz, 2009). Disallowance of compensation payments may also be costly for a corporation since this can lead to potential increased

[12] However, the Code did change when, in 1993, Sec. 162 (m) was added to regulate the deductible amount of the base salary paid to the top executives in a publicly traded corporation. As a result, the tax deduction for base salaries is now limited to $1 million for top executives. Interestingly, this cap does not apply to performance-based pay. See Kirkland (2013b) for an application and review of Sec. 162(m).

tax liabilities and litigation with the IRS (Bertozzi, 1978). The language of the IRC regarding compensation may be clear, but it has led to much litigation over the years (Bertozzi; Porcano 1982). Consequently, compensation plans must be well constructed and clearly communicated (Bolten, 2009). CPAs and other tax professionals can provide the necessary knowledge and tools to help clients navigate executive compensation issues (Kirkland, 2013a).

Many times, compensation issues arise in private, closely-held corporations, rather than in large, public corporations (Bertozzi, 1978; Cloyd et al., 1996; Fiore, 1990; Geisler & Wallace, 2005; Kirkland, 2013a; Panitz, 2009; Porcano, 1982; Vagts, 1983). A closely-held corporation can be defined as a corporation with a few shareholders or where owners and managers are represented by the same individuals (Bertozzi). This is a result of the lack of independence between officers and the board of directors, control of corporate affairs falling upon the officer-shareholder, and top executives in these types of corporations being mostly unaware that their judgment concerning compensation arrangements could be scrutinized by the IRS (Bertozzi; Kirkland, 2013a; Panitz). In addition, IRC Sec. 162 has been applied more often to closely held corporations rather than publicly-traded corporations since the checks and balances in publicly-traded corporations have been deemed sufficient and there is no independence between the shareholders, management, and directors in a closely-held corporation regarding the boundary between compensation and a distribution of profits (Bertozzi; Vagts, 1983). Another reason for the application of Sec. 162 to closely-held corporations is that most often, transactions, including compensation packages, are not conducted at arm's length,

which has caused the IRS to examine carefully compensation payments and to determine the reasonableness of those payments (Antognini, 2003; Bertozzi).

Compensation in a closely-held corporation vs. a large, publicly-traded corporation.

Compensation for U.S. top corporate executives has undergone changes since the end of World War II, but the role of compensation has especially transformed since 1990 (Boatright, 2009). Changes have come not only in the amount, but in the components of compensation as well (Boatright, 2009). Compensation in a publicly-traded corporation for executives will most often consist of a base salary, bonus, stock options, and other types of incentive programs, such as retirement plans and deferred benefits (Jarque, 2008). These different components in compensation are used to provide incentives for the executive to align his interests with that of the corporation (Jarque, 2008). In a closely-held corporation, however, compensation consists mostly of a base salary and year-end bonus (see Geisler & Wallace, 2005; Kirkland, 2013a; Recor, 2009).

Since 1990, executive compensation in large corporations has been more closely tied to performance, through stock options, to help mitigate agency problems inherent in large corporations (Boatright, 2009). For a large, publicly-traded corporation, compensation is used to align the executive with the interests of the corporation through incentive-based pay (Jarque, 2008). However, for closely-held corporations, incentive pay as compensation is mostly non-existent since many times there is no independence between the officer-shareholder and the board of directors (Bertozzi, 1978; Panitz, 2009). Likewise, it is important for closely-held corporations to base bonuses on performance that are linked to a company's goals, not on cash flow, as this is an area that the IRS scrutinizes closely (Kirkland, 2013a).

Compensation versus dividend distributions.

It has been suggested that the purpose for laws and regulations regarding compensation has been to deter corporations, especially closely-held corporations, from classifying dividend payments as salary payments in an attempt to reduce taxable income (Bertozzi, 1978; Panitz, 2009). This is specifically the case for the closely-held corporation since it can to a degree avoid the corporate level income tax by compensating officer-shareholders (Everett, Hennig, & Raabe, 2010). In addition, sufficient retained earnings would seem to imply that the availability for a dividend distribution was present but not used (Bertozzi). Even though a profitable corporation is not legally bound to pay out a dividend, when a taxable corporation does not pay dividends, the deductibility of compensation payments may be questioned (Bertozzi; Kirkland, 2013a; Recor, 2009). As suggested by Recor (2009), "a dividend by any other name is still a dividend" (p. 46), and if audited, the IRS will discover these disguised dividends and have a strong argument for reclassifying compensation payments.

Distributions out of corporate earnings that are classified as dividends are subject to double taxation, so corporations look for tax-deductible payments, such as compensation payments to corporate owners, to lower taxable income (Bertozzi). Furthermore, compensation can be used by corporations to shift income and profits to shareholders in the form of a deductible payment, rather than as a nondeductible dividend (Enis & Ke, 2003; Wilkie et al., 1996). Payments of interest and rent to corporate owners can reduce taxable income for the C corporation, but evidence from data collected by the IRS annually indicates that compensation is the most reasonable form of payment a corporation can pay corporate owners (Geisler & Wallace, 2005). This can be especially

advantageous when analyzing compensation packages with the marginal tax rates of taxable corporations. There is evidence to suggest that, as statutory tax rates change, corporations will change their compensation arrangements to avoid higher taxes and pay lower taxes at the shareholder level (see Enis & Ke, 2003; Wilkie et al., 1996).

S corporations.

In the United States (U.S.), a corporation is one of the legal forms of business. If a business entity is established as a corporation or a LLC and meets certain criteria, the owners of the entity can elect to have the entity classified as an S corporation under the IRS' check-the-box regulations. To elect S corporation status, the corporation must meet certain criteria set forth in Subchapter S of the Internal Revenue Code (IRC).[13] Currently, there is evidence to suggest that entities electing S corporation status have enjoyed tax advantages over C corporations by analyzing the payout policy of firms and marginal tax rates[14] (Denis & Sarin, 2002). As a result, the value of S corporations over identical C corporations comes at a premium by as much as 54% (Denis & Sarin).

S corporation compensation

The S corporation election is unique, given that the entity is taxed similar to a partnership while still maintaining many of the legal benefits and requirements of a corporation.[15] Entities electing S corporation status are taxed in much the same way as partnerships (Denis & Sarin, 2002). Therefore, the S corporation designation allows

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[13] The criteria that must be met and the process for election of S corporation status are referenced in IRC Sections 1361and 1362.

[14] It is important when analyzing the tax treatment of C corporations and S corporations to compare both corporate tax rates and individual tax rates. Both corporate and individual tax brackets have gone through many changes in the past few decades [see Plesko & Toder (2013) for a review].

[15] One of the significant legal aspects that shareholders enjoy from the corporate form is limited liability (Plesko, 1994).

business items, such as income and deductions, to pass to the shareholders for taxation purposes and retain the character of such items (Fiore, 1990). As a result, S corporation items flow through to a shareholder's individual tax return, and income is taxed at the individual income tax rates of the shareholder, rather than at corporate tax rates. In contrast, C corporations are taxed first at the corporate level, and shareholders are then taxed on recognized capital gains and dividend distributions (Denis & Sarin, 2002). However, even though S corporation taxation is similar to partnership taxation, in that both are pass-through entities for federal income tax purposes, each entity is treated differently when dealing with federal employment taxation at the ownership level[16] (Pullis, Zhao, Pullis, & Wadhwa, 2009).

The issue of paying compensation or paying distributions is more prevalent for closely-held corporations that have one shareholder or a few large shareholders (Fiore, 1990). Compensation arrangements for large, publicly-held corporations, with countless shareholders, are established at arm's length (Antognini, 2003). However, for closely-held corporations, compensation arrangement decisions are based primarily on tax considerations (Antognini). This is especially true for closely-held corporations that have elected S corporation status since adverse tax consequences may not exist between shareholder and corporation (Antognini). However, the number of employees does not negate the requirement that the S corporation must pay applicable federal employment

[16] In an S corporation, the officer-shareholder must be paid reasonable compensation. The officer-shareholder then pays the applicable employment taxes on the compensation, and the S corporation pays the employer portion of those employment taxes. Partners of a partnership, on the other hand, are considered pass-through taxpayers. No compensation is paid to partners, but partners are considered self-employed (for tax purposes, guaranteed payments –which may be outlined as compensation in a partnership agreement, are not considered compensation). As a result, partners must pay self-employment taxes on their personal tax returns. See Antognini (2003), Fellows & Jewell (2006), Martin (1995), and Pullis et al. (2009) for complete discussions regarding S corporation compensation and partnership guaranteed payments.

taxes for those employees (Pullis et al., 2009). As long as the corporation (even a closely-held S corporation) participates in a business activity, it is presumed that the corporation has at least one employee (Pullis et al.). If there is a sole shareholder of an S corporation that provides any type of service to the business, the shareholder will be classified as the employee of the S corporation by the courts (see *Radtke v. United States* 1989/1990).

When comparing compensation payments of both C corporations and S corporations, the treatment is generally the same. Compensation will provide the corporation with a business deduction, while the compensation payments will increase the employee's income (Antognini, 2003). As a result, compensation paid by a C corporation allows the corporation to offset one level of taxable income: the business deduction reduces the C corporation's taxable earnings. This indirectly reduces the effect of double taxation inherent in C corporations.[17] However, S corporations are not subject to double taxation, so compensation paid does not have the same advantage as with C corporations since there is effectively only one level of taxation (Antognini).

One tax advantage of electing S corporation status is the avoidance of double taxation that is characteristic of C corporations. For C corporations, income at the corporate level is taxable, and it is taxable again once the profits of the corporation are distributed as dividends to the shareholders. By electing S corporation status, businesses can enjoy considerable tax savings by avoiding double taxation since S corporation

[17] Double taxation refers to the phenomenon of taxes imposed both on C corporation income and dividends to shareholders. Consequently, shareholder dividends are required to be included in gross income [see IRC Sec. 301(c)(1)], while dividends are not corporate business deductions (see IRC Sec. 162). Interestingly, the merit of double taxation being a disadvantage arises when a corporation has more than $75,000 of taxable income (see Calcagni, 2010 for a review).

taxable income flows through to each shareholder's tax return. When distributions are made from the S corporation, they are not taxed. Distributions from an S corporation are simply treated as a return of basis [18](Antognini, 2003).

Another advantage of electing S corporation status for a business entity is the characterization of the income that flows through to the shareholder. The income from the S corporation that flows through to the shareholder is not taxed as self-employment earnings, and therefore are not assessed self-employment taxes, as income from other entity types such as sole proprietorships and partnerships are taxed. Unlike distributions from a partnership, which are assessed self-employment taxes, S corporation distributions to shareholders are not considered self-employment earnings[19] (Pullis et al., 2009). Self-employment taxes, which include Social Security and Medicare taxes, are not assessed on S corporation earnings on a shareholder's tax return. Thus, at the federal level, a shareholder is assessed only federal income tax on the earnings from the S corporation. This can also be a significant area for tax savings for officer-shareholders, as employment taxes would not be paid if the officer-shareholder took little or no salary from the S corporation (Antognini, 2003).

However, one of the requirements of electing S corporation status is that officer-shareholders must take a reasonable wage or salary for services provided to the

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[18] Distributions from an S corporation are tax-free to the extent of the shareholder's basis in his S corporation stock and reduce the shareholder's basis. However, earnings from an S corporation increase a shareholder's stock basis. Thus, when an officer-shareholder is paid a distribution, taxes have already been assessed initially when the income was reported on the shareholder's own individual tax return. As long as the earnings from the S corporation allocated to the shareholder are increasing the basis at a rate greater than the distributions being paid, the officer-shareholder will not have adverse tax consequences from distribution payments (see McCoskey & Fellows, 1997; Antognini, 2003).

[19] Self-employment taxation is reference in I.R.C. §1401. The characterization of earnings of an S corporation as non-self-employment earnings is found in I.R.C. §1366(a)-(b) (see also Rev. Rul. 59-221, 1959-1 CB 225; *Ding v. Comr.*, 1997/1999).

corporation, unless the officer-shareholder provides very little services or none at all[20]. For S corporations, profit of the company may be paid as a distribution, but some of the profit also needs to be paid in the form of compensation to the officer-shareholder whose services helped the corporation earn that revenue (Pullis et al., 2009). This criterion is specifically outlined in CP261, the IRS notice that indicates acceptance of the S corporation election (Ledgerwood, 2010). Rather than acting as a simple acceptance of S corporation status, a substantial portion of the CP261 notice now explicitly outlines the tax requirements for an S corporation officer-shareholder's compensation (Fellows & Jewell, 2006). In addition, this requirement can be found in the instructions for Form 1120S, which specifically states that "distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation," (IRS, 2013, p. 15).

When an officer-shareholder takes a salary or wage, the S corporation can deduct the salary expense, but the corporation must also pay the employer portion of employment taxes on the salary, such as Social Security, Medicare, and Federal Unemployment (FUTA) taxes[21] (Johnson, 2012; Pullis et al., 2009). This allows for the government to collect Social Security, Medicare, and other employment taxes on compensation that it would not otherwise collect if the profits flow through to the officer-

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[20] "Wages" are defined as any compensation paid for employment [I.R.C. §§ 3121(a), 3306(b)], while "employment" is defined as any service, no matter the nature of that service, that is performed by an employee for an employer [I.R.C. §§ 3121(b), 3306(c)]. Interestingly, for FICA (social security and Medicare) and FUTA purposes, an officer of the corporation is considered an employee, as defined by common-law rules, unless the officer does not provide substantial services [see Treas. Reg. § 31.3121(d)-1(b); I.R.C. §§ 3121(b), 3306(c)].

[21] In addition to these taxes assessed at the Federal level, state unemployment taxes (SUTA) are assessed at the state level. Officer shareholders must also consider the state in which the S corporation operates. Some states' regulations regarding S corporations directly contradict federal law, thereby adding an additional level of complexity when establishing the characterization of such payments as compensation or distributions (see Kaplan, 1994).

shareholder. For the S corporation and the officer-shareholder, this results in tax savings on income earned above the salary since this income is not subject to these employment taxes. Therefore, officer-shareholders attempt to minimize taxes paid by keeping wages low and taking distributions, and allowing the resulting profits to pass to the shareholder at the same tax rate, but without the implication of Social Security, Medicare, and FUTA. In addition, an aggressive tax position some S corporations choose is to pay no compensation to its officer-shareholder (Kirkland, 2013b). At best, these scenarios, or even classifying the officer-shareholder as an independent contractor, are risky for the taxpayer, as evidenced by the court case *Nu-Look Design, Inc.* (2003/2004) (Pullis et al.). In this court case, the dispute focused on if the sole shareholder who was a corporate officer was indeed an employee of the corporation. The sole shareholder provided substantial services to the business and did not take a salary, but the shareholder would take distributions when needed. This "arrangement" allowed the corporation to bypass FICA and FUTA employment taxes. Ultimately, the S corporation did not win the case, and the corporation and shareholder owed taxes for distributions reclassified as compensation. This was a risky position to take for the S corporation, because once the case was upheld in court, the S corporation was not granted penalty relief under the safe harbor rules of Sec. 530 of the Revenue Act of 1978. As a result, the S corporation and shareholder were also responsible for the penalties on all of the unpaid taxes resulting from the reclassification.

As evidenced by the *Nu-Look* case, if reasonable compensation is not paid when required, the distributions payments made in place of reasonable compensation could

potentially be re-characterized by the IRS as salary payments under Rev. Rul. 74-44,[22] which the IRS has somewhat successfully accomplished in recent years (Antognini, 2003; Segal, 2003). Distributions out of corporate income to officer-shareholders have not been the only type of payment to be reclassified as compensation (Fellows & Jewell, 2006; Fellows & Jewell, 2007). The reclassification of distributions, other types of payments, or S corporation earnings to officer-shareholder compensation can have adverse effects on the S corporation's after-tax cash flow due to penalties and interest related to the reclassification (Fellows & Jewell, 2006).

The interesting aspect of this tax advantage is that the IRS only defines the amount of wages that officer-shareholders should take as "reasonable compensation." For that reason, it is the tax professional that recommends a reasonable wage as part of the tax services provided to an S corporation. Even though the IRS does not provide an absolute definition as to what constitutes a reasonable wage, the IRS does identify several factors that can provide assistance in determining reasonable compensation. According to IRS fact sheet FS-2008-25, these factors are training and expertise, duties and responsibilities, time and effort devoted to the business, dividend history, payments to non-shareholder employees, timing and manner of paying bonuses to key people, what comparable businesses pay for similar services, compensation agreements, and the use of a formula to determine compensation[23] (IRS, 2008). For example, one approach that has

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[22] Revenue Ruling 74-44, Internal Revenue Service (January 1, 1974). The IRS ruled in this Revenue Ruling that dividends paid to shareholders were made in place of reasonable compensation rather than as a normal distribution of the corporation's profits. Since the dividends were deemed to be compensation, the shareholders were assessed employment taxes on the re-characterized salary payments.

[23] It is important to note that the items outlined in the IRS fact sheet are similar to the five-factor test used to determine reasonable compensation for C corporation officer-employees, which was first introduced in the court case, *Elliotts, Inc., v. Comm'r* (1999). The elements of the five-factor test were: (1) examine the employee's role within in the company, (2) externally compare the salary paid with other similar employees and corporations, (3) analyze the company's current character and condition, (4) investigate

been developed and used by tax practitioners is the 60-40 formula, even though it has not been sanctioned by the IRS or by the courts (Fellows & Jewell, 2007). Under this approach, payments made to an officer-shareholder are deemed to be 60% salary and 40% distributions. Other variations for the split between what represents salaries and distributions could be used, depending upon the circumstances relating to each case. Likewise, under this approach, salary payments could be established as a percentage of gross revenue or net business income prior to the salary expense (Fellows & Jewell; Ledgerwood, 2010).

Practically, an officer-shareholder should consider what the corporation would have paid to someone else had they performed the job. By contemplating this position, many of the factors that should be addressed in determining reasonable compensation would be given proper consideration (Ledgerwood, 2010). In addition, it has been found that the compensation amount be directly related to and be determinate upon the skill level and the role in which the officer-shareholder has in the S corporation (Fellows & Jewell, 2006).

It has also been shown that determining a reasonable compensation amount for the officer-shareholder is not dependent on certain factors. The economic status of the S corporation (earning profits or incurring losses) has had no bearing in determining whether compensation should be paid to the officer-shareholder (Fellows & Jewell, 2006). Likewise, the status of the officer-shareholder, whether full-time or part-time, did not have any relevance in establishing whether compensation should be paid (Fellows &

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possible conflicts of interest by using return on equity (ROE), and (5) consider whether there was a constituent internal compensation program. See the section titled within this study, "Establishing the concept of reasonable compensation," for further discussion of the five-factor test as it relates to reasonable compensation.

Jewell; *Veterinary Surgical Consultants*, 2001). Many times, the courts allow the IRS to negotiate reasonable compensation with the taxpayer (Fellows & Jewell). Should an officer-shareholder be audited and an agreement cannot be reached as to what constitutes reasonable compensation, the issue will then be taken to the courts (Ledgerwood, 2010). Many times, once a case has made it to the court system, the amount of reasonable compensation will be determined case by case.

As a result of these tax advantages, entities electing to operate as S corporations are increasing and have become an attractive and popular business form (Calcagni, 2010; Fellows & Jewell, 2013; Segal, 2003; Wilkie, Young, & Nutter, 1996). Since the Tax Reform Act of 1986 was enacted, there have been substantial shifts in organizational forms and tax treatments, specifically taxable corporations electing to be taxed as S corporations (Mackie-Mason & Gordon, 1997). Evidence of the popularity of S corporation elections has also come from the increase in the number of tax returns that have been filed with the IRS in recent years.[24] Additionally, pass-through entities, such as S corporations, make up a large portion of economic activity relative to taxable corporations (Plesko & Toder, 2013). As these elections are increasing, the attempt by the IRS to pursue the suspected abuses of low wages and high dividend distributions to officer-shareholders is also increasing (Johnson, 2012). This is supported by the number of court cases that the IRS has won in recent years, where the IRS has been able to reclassify payments to the shareholder, such as dividends, distributions, or loan

[24] For tax years 2003-2012, the number of S corporation returns (Form 1120S) as a percentage of total corporate tax returns filed has increased from 57% to 67%, while C corporation and other returns (Forms 1120 series) have decreased as a percentage of total corporate tax returns filed, from 43% to 33%. These statistics were obtained from the IRS Statistics of Income Bulletin (IRS Data Book) for years 2003-2012 (Table 2 – Numbers of Returns filed by Type of Return).

repayments, as shareholder compensation (Antognini, 2003; Fellows & Jewell, 2006; Johnson; Pullis et al.). Such reclassification gives taxpayers little ability to evade the compensation-distribution issue because of the magnitude the IRS' influence has for this issue (Antognini; Fellows & Jewell; Johnson; Pullis et al.).

Court cases – S Corporations.

Because of the tax benefits associated with low compensation and high distribution amounts to officer-shareholders of S corporations, officer-shareholders have pursued this avenue of tax savings for quite some time. For small corporations, tax avoidance decisions have many times involved questions of compensation (Geisler & Wallace, 2005). Furthermore, a study performed by Cloyd, Pratt, and Stock (1996) suggest that public corporations are less likely to manage tax strategies aggressively than private corporations. Consequently, this has led to the IRS challenging, through the court system, many avenues that these taxpayers from small corporations use to reduce tax liabilities.

Interestingly, once taxable C corporations reach certain income tax brackets, there is the incentive to increase shareholder compensation to reduce taxable income, despite increased employment taxes associated with increases in compensation. Even so, compensation paid to shareholders of C corporations must still be reasonable, otherwise the IRS is likely to reclassify portions of the compensation as a constructive dividend and the corporation loses the business deduction[25] (Geisler & Wallace, 2005). In contrast, S corporations have little if any incentive to compensate officer-shareholders (Geisler &

[25] Reasonable compensation for C corporations is governed by IRC Sec. 162. Interestingly, for C corporations, the compensation dollar amount is examined for reasonableness since C corporations may intend to use compensation as a deduction to reduce taxable income and ultimately tax liabilities.

Wallace). S corporation income flows through to shareholders, so a business deduction does not carry the same weight as it does for C corporations. In this way, officer-shareholders of S corporations instead take distributions to avoid employment taxes from compensation (Pullis et al., 2009). Because of this difference between C and S corporations, numerous court cases have arisen due to S corporation officer-shareholders avoiding compensation.

Since 1978, a guiding theme throughout S corporation compensation court cases is that the courts will immediately examine the substance of a transaction, as well as the underlying economic reality of the proposed transaction, not simply the literal form of the transaction itself, as evidenced by the court case, *Frank Lyon Co. v. United States* (1978).[26] Interestingly, in court cases dealing with S corporation compensation, the *Lyons* court case has been cited numerous times as a reason why the judges looked past the mere form of the transaction, and intensely scrutinized the underlying economic substance of the transaction in question.

The most common types of tax strategies involving S corporation officer-shareholders that have gone to court involve officer-shareholders receiving little or no compensation and receiving significant distribution amounts, claiming that the

[26] In the court case, *Frank Lyon Co v. United States* (1978), The Lyon Co. became the title owner of a building and leased the building back to Worthen Bank for long-term use (with an option to repurchase), when Worthen Bank realized that it could not finance the construction of the building with a conventional mortgage and other types of financing. The Lyon Co. accrued rental income from the bank and claimed deductions for the building on its tax return in the year the building was complete and the bank took occupancy, but the Commissioner of the Internal Revenue Service disallowed the deductions for the building, claiming that The Lyon Co. was not the owner of the building for tax purposes due to the sale-and-leaseback transaction with Worthen Bank. In the end, the court ruled that since The Lyon Co.'s capital was invested in the building, it could claim the deductions related to the transaction. The court also concluded that this transaction was not merely a tax avoidance transaction, but a multi-party transaction with economic substance due to state and regulatory issues, and the transaction was independent of tax considerations.

shareholder is an independent contractor, or characterizing all S corporation income as a distribution to the shareholder (Pullis et al., 2009). In addition, some officer-shareholders have attempted to "compensate" themselves through corporate loans. However, the courts have not excluded loans from also being reclassified as shareholder compensation (Antognini, 2003; Fellows & Jewell, 2006; Johnson, 2012; Pullis et al., 2009).

Employees classified as independent contractors.

Previously, there have been court cases involving whether individuals should be classified as employees or independent contractors for S corporations. These cases are relevant, due to the possible outcome of misclassification, which may result in employment taxes not being paid. These court cases involved the S corporation classifying a shareholder as an independent contractor to avoid paying employment taxes on an employee's salary. If misclassification occurred on a reasonable basis, the safe harbor rules involving tax relief from the misclassification found in Sec. 530 of the Revenue Act of 1978 are applied. However, if misclassification occurred and no reasonable basis was found, the courts denied tax relief under Sec. 530. In *General Investment Corp. v. United States* (1987), the safe harbor rules applied to the corporation when they misclassified an employee as an independent contractor since "reasonable basis" was to be "construed liberally in favor of taxpayers" (p. 3). However, in the court cases, *Thomas J Greco v. United States* (2005) and *Peno Trucking, Inc. v. C.I.R.* (2007), the courts upheld that employees were misclassified as independent contractors, and tax relief from Sec. 530 of the Revenue Act of 1978 was not granted.

At times, S corporation officer-shareholders have used misclassification as a defense in not paying compensation to officer-shareholders, anticipating tax relief under

Sec. 530 of the Revenue Act of 1978. A great example of this is found in the court case, *Veterinary Surgical Consultants* (2001). In this case, the court upheld that section 530 of the Revenue Act of 1978 could not be used since the corporation had no reasonable basis for not classifying the sole shareholder as employee. For this case, the corporation did not pay wages to the sole shareholder, but instead distributed all income to the shareholder. Interestingly, the shareholder argued that this was in line with Sec. 1366 of the IRC, but the court rejected this argument, stating that Sec. 1366 did not apply to calculations of employment taxes, but only how shareholders should report income solely for tax purposes.

Officer-shareholders and compensation.

There are noteworthy court cases that have occurred in the last thirty years that deal with S corporation officer-shareholders taking little or no wages, but rather "compensating" themselves through distributions and dividend payments. The underlying themes of these court cases was that the officer-shareholders of the S corporations did not pay themselves wages, were paid distribution payments, and provided substantial services to the S corporation. These court cases are *Radtke v. United States* (1989/1990), *Spicer Accounting v. United States* (1990), and *Yeagle Drywall Co.* (2001).

In *Radtke v. United States* (1989/1990), dividend payments to a sole shareholder of a legal service corporation, which elected S corporation status, were reclassified as compensation, and the corporation owed employment taxes on the reclassified payments, as well as interest and penalties. The reclassification occurred as a result of the sole shareholder being the only full-time employee of the corporation and cited the court case,

Greenlee Inc. v. United States (1985), as a reminder that corporations could not classify payments as something other than wages for the sake of avoiding taxes. In addition, the *Lyons* case was cited, as the courts looked to the substance of the economic transaction and not the form since transactions between a closely-held corporation and its shareholder warrant additional scrutiny.

The court case, *Spicer Accounting v. United States* (1990), was one where dividends were paid to one of two shareholders, and the dividend payments were found to be compensation. The shareholder was the only accountant working for the firm, and his services were deemed valuable by the courts since the corporation relied solely on his services to operate as an accounting firm. In the end, the courts also ruled that the shareholder was not an independent contractor, and the safe harbor rules of Sec. 530 of the Revenue Act of 1978 did not apply to the employment taxes for which the corporation was liable since there was no reasonable basis for such classification as independent contractor instead of employee.

In *Yeagle Drywall Co.* (2001), dividend payments to a 99% shareholder were reclassified as compensation, due to the shareholder providing substantial services for the business and maintaining authority over the corporation's bank accounts. The corporation argued that distributions were made from its income, pursuant to Sec. 1366. Relief under Sec. 530 of the Revenue Act of 1978 was also not granted, because there was no reasonable basis for not classifying the shareholder as an employee. Under Sec. 530, relief may be granted if the corporation had a reasonable basis for not treating an individual as an employee. Reasonable basis is determined from a corporation's reliance on past court cases, published rulings, technical advice, letter rulings, IRS audits, or

significant practices within an industry segment (Nash, 2012). Yeagle Drywall Co. relied on the argument in the court case, *Veterinary Surgical Consultants* (2001). Furthermore, *Veterinary Surgical Consultants* (2001) relied on an excerpt from the court case, *Durando v. United States* (1995) as a reasonable basis for classification. In the *Durando* case, it was determined that income earned by a corporation did not have to be treated as earned by shareholders, even though a shareholder's services produced the corporation's income; this determination was in relation to self-employment income and retirement plans, not distributions to an officer-shareholder of an S corporation. Consequently, for purposes of the *Yeagle* case, the court determined that this position was not a justification for the reasonable basis test for the misclassification of the shareholder's distribution payments, and penalty relief under Sec. 530 was not granted.

Reclassification of shareholder loans as compensation.

Other strategies that officer-shareholders have employed to avoid compensation is through the use of other types of payments. These payments could be in the form of "loans" or payments made on behalf of the officer-shareholder for personal expenses as needs arose. Several court cases have involved these other types of payments, and ultimately, even these payments were not out of reach from the courts reclassifying these payments as compensation. As a result, these reclassified payments were also subject to the same employment taxes in the same manner as any other compensation payment.

For the case, *Greenlee Inc. v. United States* (1985), the courts reclassified loans made to the shareholder as compensation since it was determined that the loans were in place of wages not paid to the shareholder. This determination was the result of the shareholder providing valuable services to the corporation, and the loans did not bear any

interest and were made at the shareholder's preference. Likewise, the courts determined that payments to repay the loan did not actually happen, but were paper transactions that were offset by other payments that the corporation owed to the shareholder. Therefore, the S corporation was liable for FICA and FUTA taxes on the loans it made to its shareholder.

Likewise, in *Joly V. Comm'r* (1998/2000), loans to shareholders of an S corporation were reclassified as wages. The argument from the shareholders that they were not employees because they were officers and that there services were insignificant were not upheld in court. The courts held that they were employees by way of being officers of the corporation and because they were involved in the daily operations of the business. As a result, the loans were reclassified as wages, and a 20% negligence penalty was imposed. In addition, of significance in this case is that the courts did not uphold written agreements between the corporation and shareholder that outlined the salary and loan arrangements, which demonstrates that the courts nor the IRS are compelled to uphold any written agreement between an officer-shareholder and the corporation.

In *Olde Raleigh Realty Corporation v. Commissioner* (2002), the court upheld the IRS' conclusion that the shareholder was an employee of the corporation, and that payment of the shareholder's personal expenses out of the corporate accounts constituted wages which were then subject to employment taxes. Because of this, penalties were assessed on the unpaid employment taxes.

Joseph M Grey *(2002/2004) and related court cases.*

Interestingly, there are six cases that encompass a couple of the common S corporation tax strategies. They involved the officer-shareholders not taking any

compensation even though they provided significant services and having personal expenses paid as needed, which were classified by the corporation as distributions out of profits (see *Mike J Graham Trucking, Inc., v. Commissioner*, 2003/2004; *Superior Proside, Inc., v. Commissioner*, 2003/2004; *Specialty Transport and Delivery Services, Inc., v. Commissioner*, 2003; *Nu-Look Design, Inc., v. Commissioner*, 2003/2004; and *Water-Pure Systems, Inc., v. Commissioner*, 2003/2004). Furthermore, at times, the officer-shareholder would receive payments resembling classification of the officer-shareholder as an independent contractor (see *Joseph M. Grey v. Commissioner*, 2002/2004).

In *Joseph M. Grey v. Commissioner* (2002/2004), Grey was an accountant and the sole shareholder of an S corporation, through which his accounting practice operated. The shareholder did not take any wages, but withdrew funds from the corporate accounts as needs arose. These withdrawals were classified as distribution of profits from the corporation. However, at times, the corporation did make small payments to the shareholder that were classified as if the shareholder were an independent contractor. The court upheld that the officer-shareholder provided substantial services to the corporation, and therefore, should be classified as an employee, and the withdrawals made from the corporate accounts were actually compensation and subject to employment taxes. Interestingly, tax relief from sec. 530 of the Revenue Act of 1978 was not granted in this situation, as there was no reasonable basis for the misclassification of the shareholder.

Remarkably, there were five other decisions that were related to the *Grey* case. These cases were all connected, in that the corporations had received accounting advice

and services from Joseph Grey. Each case had essentially the same issue: no compensation was paid to controlling shareholders that provided substantial services to the businesses and no tax relief from Sec. 530 was granted and are summarized below.

In *Mike J Graham Trucking, Inc., v. Commissioner* (2003/2004), the owner and president of the S corporation provided services, but the S corporation did not report any employees during the years in question. The courts cited sections of the IRC as the basis for classifying the shareholder as an employee.[27] However, the court determined that the services provided by the shareholder were substantial and therefore the payments made to him were considered compensation. The courts also concluded that there was no reasonable basis for the corporation to not classify the shareholder as an employee due to the services rendered. In the end, the courts ruled that the shareholder was an employee; the corporation was not entitled to tax penalty relief under Sec. 530; and the corporation was liable for all applicable payroll taxes associated with the payments that were reclassified as compensation.

In *Superior Proside, Inc., v. Commissioner* (2003/2004), the president and owner of the S corporation was the sole shareholder since its inception. During the years under investigation, the corporation did not make regular payments to the shareholder for services, but the shareholder withdrew funds from the corporation on a needs basis. The sole shareholder was the only individual to provide services to the corporation, and it did

[27] The courts cited Subtitle C of the IRC, which regulates employment taxes. Specifically, the courts cited §§3111 and 3301, which require employers to pay FICA and FUTA on all applicable wages to employees. In addition, the courts cited §3121(d) as a basis for determining the definition of an employee for the shareholder in question, which states that an employee includes any officer of a corporation. The only exception that an officer of a corporation not be classified as an employee is if the officer did not provide substantial services to the corporation and who did not receive or entitled to receive payments from the corporation. Otherwise, the officer is considered an employee for purposes of §3121(d). In this case, since the shareholder was also the president, he had to be classified as an employee.

not report any employees or salary compensation for those tax years. Yet again, the courts cited sections of the IRC as the basis for classifying the shareholder as an employee.[28] Therefore, the courts concluded, based on the duties performed by the shareholder that the services were not minor and that the payments to shareholder should have been classified as compensation. As a result, the court ruled that the shareholder was an employee; the corporation was not entitled to relief under Sec. 530; and the corporation as liable for all applicable payroll taxes based on payments reclassified as compensation for those tax years.

In *Specialty Transport and Delivery Services, Inc., v. Commissioner* (2003), the courts determined that the president and owner of the S corporation should have been classified as an employee. The owner was the sole shareholder and handled all significant aspects of the corporation's daily operations. The shareholder withdrew funds as his needs arose. Thus, the funds paid to the shareholder were reclassified as compensation. The courts ruled that the corporation did not have a reasonable basis for not classifying the shareholder as an employee, and therefore, were not entitled to tax penalty relief under Sec. 530. In addition, the courts ruled that the corporation was liable for all payroll taxes associated with the reclassified compensation for the tax years in question.

Furthermore, in *Nu-Look Design, Inc., v. Commissioner* (2003/2004), the owner was the sole shareholder of the business and it was determined that he managed all of the

[28] As with all the court cases related to the *Joseph M. Grey* case, the courts again cited Subtitle C of the IRC, which regulates employment taxes. Specifically, the courts cited §§3111 and 3301, which require employers to pay FICA and FUTA on all applicable wages to employees, and §3121(d) as a basis for determining the definition of an employee for the shareholder in question. Again, the shareholder was the president of the company and therefore should be classified as an employee.

corporation's daily operations. Therefore, the courts ruled that the owner was an employee based on services rendered to the corporation. The corporation challenged the ruling, citing that it had correctly distributed its net income to the shareholder during the tax years in question. But the courts ruled that this was not a matter of distribution, but an issue of classification. Consequently, the corporation did not have a reasonable basis for not classifying the shareholder as an employee and was not entitled to relief under Sec. 530. The payments made to the shareholder were reclassified as compensation, and the corporation was held responsible for all applicable payroll taxes for those tax years.

Lastly, in *Water-Pure Systems, Inc., v. Commissioner* (2003/2004), the president and owner was the sole shareholder of the corporation. The corporation did not classify him as an employee and did not report any other employees, but he managed all aspects of the business operations for the corporation, and he withdrew funds as his needs arose. As a result, the court determined that the shareholder was an employee because of the services he provided, and the payments to the shareholder were reclassified as compensation. The corporation was not entitled to tax penalty relief under Sec. 530 and was responsible for all applicable payroll taxes.

Reasonable compensation.

Court cases involving S corporations and their shareholders have not only encompassed reclassification of officer-shareholder compensation. There are court cases that have expanded the courts' reach into the compensation debate by introducing opinions about what constitutes a reasonable wage for officer-shareholders.

In *Wiley L Barron v. Commissioner* (2001), the Tax Court upheld an IRS agent's determination of what was a reasonable compensation amount by using guidance from

statistical data in the applicable industry, region, and timeframe. Again, in this case, the shareholder took large sums of distributions for the years in question and was not paid compensation. Interestingly, for one of the years in question, the officer-shareholder was paid a very small salary, and as a result, the Tax Court upheld that relief under Sec. 530 of the Revenue Act of 1978 did not pertain to this case.

Moreover, in *David E Watson* (2012), David Watson transferred his ownership of an accounting firm into a professional corporation that elected S corporation status. Watson, the sole shareholder of the corporation, was employed by the corporation through an agreement, but the majority of his services were in connection with the accounting firm. The corporation paid $24,000 as employee compensation to the shareholder in 2002 and 2003, but distributed substantially more to the shareholder in both of those years. The IRS assessed taxes and penalties on the distributions when it determined that certain portions of the distributions should have been classified as additional compensation to the shareholder. The court upheld the IRS' position, because the form of the transactions involved was not as significant as the actual economic substance of those transactions, which involved analyzing the actual services performed by the shareholder. In the end, the fact that the shareholder was a CPA with a college education and devoted more than 35 hours a week to constituted his services as substantial. Therefore, his salary was considered too low by the courts and the courts determined the actual value of services rendered for the shareholder.

It is clear from the number of court cases in recent years that the reasonable compensation issue for S corporation officer-shareholders remains. It can be seen through court cases that reasonable compensation is a unique issue for corporations

electing S corporation status, due to the tax laws set forth in the Internal Revenue Code and other legislative sources. By examining past court cases, it is evident that this issue is an existing, ambiguous tax issue, warranting further study.

Motivations for Obtaining Tax Preparers.

Income tax professionals are certainly an integral part of the tax system in the United States (U.S.) (Reinganum & Wilde, 1991). An income tax preparer is defined by the IRC as one who is compensated for tax return preparation (see IRC §7701(a)(36)). The complexity involved in preparing tax returns is evidenced by the number of returns prepared by professional preparers (Ayres, Jackson, & Hite, 1989; Christian, Gupta, & Lin, 1993; Hansen & White, 2012). There are many reasons why taxpayers will hire a professional to prepare their tax return, including, but not limited to, preparation time, tax minimization, and complexity of the return. Economic theory would suggest that if it costs more in time or money to perform some action by oneself than to hire help, the individual hires help (Stephenson, 2007). Other possible reasons that taxpayers are using tax professionals more and more are increasing complexity of the federal income tax system, aversion to audit, time efficiency, tax liability minimization, legal compliance, and uncertainty (Fleischman & Stephenson, 2012; Frischmann & Frees, 1999; Hite & McGill, 1992). In addition, taxpayers with higher incomes and more complex tax returns are more likely to seek help from paid professionals than are other taxpayers (Stephenson).

It is shown in the literature that taxpayers have accuracy as their main objective for hiring a tax professional, especially when the taxpayer has low tax knowledge and a complex tax situation (Collins, Milliron, & Toy, 1990). This is relevant since research

suggests that taxpayers do not hire tax professionals simply out of fear of the IRS (Collins et al.). Clients also hire professional tax preparers to advocate for them. Fleischman and Stephenson (2012) found that clients hired tax professionals to advocate for them, and advocacy was positively and significantly related to reasons for hiring professionals consistently found in tax research, such as saving time, money, compliance, and contact with the IRS. In addition, taxpayers hire a tax professional for other reasons, even when the possibilities of preparation without third-party help have become easier in recent years due to advances in tax return software. This is evidenced by the fact that, in 2003, while market share for tax software programs was increasing, over 60% of returns filed were prepared by a tax professional, while the number of tax returns filed that used tax software was approximately 25% (Guyton, Korobow, Lee, & Toder, 2005).

It is demonstrated throughout the tax and accounting literature that there are mixed differences between taxpayer and tax preparer perceptions and the demand for services (see Christensen, 1992; Dubin, Graetz, Udell, & Wilde, 1992; Schisler, 1995). Christensen suggests that there is a gap between what taxpayers expect from their tax professionals and what tax professionals think their clients expect. Taxpayers are mostly interested in filing accurate returns, while tax preparers equate client advocacy with aggressive tax advice and positions (Hite & McGill, 1992; Stephenson, 2007). This gap can lead to inappropriate decisions for the taxpayer if their tax goals are misunderstood (Hite & McGill).

Studies that have focused on the demand for tax preparation services have yielded interesting results. Christian et al. (1993) find that the time-cost of tax preparation is an important determinant of preparer usage, even after controlling for complexity. In

addition, they do not detect an association between income or tax rate and preparer use after controlling for time-cost, complexity, and sources of income. Dubin et al. (1992)'s study suggest that an increase in the percentage of the adult population who graduated from high school and increases in wages, interest, and dividends significantly decreased the demand for most types of third-party assistance. On the other hand, Dubin et al. also suggest that increases in IRS audit rates; frequency of penalties; and deductions, such as state, local or real estate taxes; were likely to increase the demand for tax preparation services. The results of the study performed by Beck, Davis, and Woon-Oh (1996) suggest that taxpayers who had the most uncertainty about their tax liability purchased tax advice more often than did other taxpayers.

Client Advocacy.

The role of advocacy is demonstrated in two forms for tax professionals. Professional standards expect tax professionals to serve as both an advocate for their clients and for the government. Unlike other accounting environments, the tax environment is unique, because tax professionals are expected to be an advocate for clients by making tax recommendations in the interest of the client (Cuccia & McGill, 2000), but the role as client advocate should not bias any tax professional's recommendations (Bobek et al, 2010). A tax professional's role as dual advocate has been investigated for some time and is an important construct in tax settings. Tax professionals' attitudes, opinions, and behaviors have been central to studies involving advocacy, and the importance of advocacy is evidenced by the number of studies, both academic and governmental, that have taken place since the 1970s (Jackson & Milliron, 1989). Likewise, this role has garnered much attention since neither the IRS nor tax

practitioners can agree to a point where the tax professional's role should lie on the advocacy spectrum (government agent versus client advocate) (Brody & Masselli, 1996; Milliron).

Tax professionals are required by the AICPA to be an advocate for their clients. This advocacy is addressed in the Statements on Standards for Tax Services (STSS) No. 1. However, this STSS also explains that a tax professional has an obligation to uphold the tax system. Specifically, STSS No. 1 states that "when recommending a tax return position, a member has both the right and the responsibility to be an advocate for the taxpayer with respect to any position satisfying the aforementioned standards" (AICPA, 2010, p. 10). The STSS also states that:

> In addition to a duty to the taxpayer, a member has a duty to the tax system. However, it is well established that the taxpayer has no obligation to pay more taxes than are legally owed, and a member has a duty to the taxpayer to assist in achieving that result. (AICPA, 2010, p. 11).

To this end, the tax professional has a dual advocacy stance when it relates to tax return preparation, as tax professionals fulfill a unique function in the tax system in having to consistently advocate for opposing demands from the government and taxpayers (Johnson, 1993). However, professional standards also state that tax professionals must recommend tax positions only when the tax professional "has a good-faith belief that the position has at least a realistic possibility of being sustained administratively or judicially on its merits if challenged" (AICPA, 2010, p. 10). These standards demonstrate that a tax professional can advocate for their clients, but a tax professional should not recommend frivolous tax positions in the name of advocacy (Brody & Masselli, 1996). As a result,

there is also the assumption in the professional standards that advocacy will not lead a tax professional to inaccurately assess the level of support for a client's desired tax position (Cloyd & Spilker, 1999).

It is important to distinguish between client advocacy and client preference since client advocacy is an internal construct and client preference is an external construct (Pinsker et al., 2009). In the literature, client preference can be defined as effects that "occur when a client clearly states a desired outcome or accounting treatment and the auditor behaves in a manner consistent with the client's wishes," (Haynes, Jenkins, & Nutt, 1998, p. 89). Mason and Levy (2001) construct the definition of client advocacy based on professional standards and the tax literature:

> Advocacy is a state of mind in which one feels one's primary loyalty belongs to the taxpayer. It is exhibited by a desire to represent the taxpayer zealously within the bounds of the law, and by a desire to be a fighter on behalf of the taxpayer (p. 127).

This study specifically investigates a tax professional's client advocacy, although client preference has been shown to influence a tax professional's loyalty to clients (see Cuccia, et al., 1995; Johnson, 1993; Nelson, 2003).

Mason & Levy (2001) indicate that "the role of tax professionals as client advocates is central to tax practice" (p. 124). According to professional standards, acting as a client advocate allows tax professionals to focus on favorable tax positions for their clients that are within the bounds of the appropriate authority. One advocacy service that a tax professional provides is helping taxpayers understand how to report uncertain tax transactions on their tax returns through research (Cloyd & Spilker, 1999), and this

guidance regarding ambiguous tax issues comprises a significant portion of the services tax professionals provide (Kaplan, Reckers, West, & Boyd, 1988). Research also indicates that an accountant's professional role influences advocacy attitudes (Pinsker, Pennington, & Schafer, 2009).

Research regarding uncertainty lends itself to collecting information that supports a current belief or preferred position, which has been studied in both the audit and the tax settings (Cloyd & Spilker; Hackenbrack & Nelson, 1996). Ambiguity in the tax law exists, and as a result, determining tax liabilities may be subjected to interpretation of the law and the tax professional's own judgment (Reckers, Sanders, & Wynedelts, 1991). Tax professionals then fulfill this service by acting as an advocate for their clients. However, despite tax law ambiguity and their role as client advocates, tax professionals must still analyze all relevant facts and tax law authority when making tax recommendations (Cloyd & Spilker; Davis & Mason, 2003) and be aware that their role as client advocate may bias their recommendations (Mason & Levy, 2001).

Tax professionals are important for tax planning and tax compliance, especially in identifying the best tax treatment for an ambiguous tax transaction (Cloyd, 1995); but client advocacy may cause a tax professional to perform a biased information search for supporting a client's preferred tax position and overestimate the level of support the information provides for that given tax position (Cloyd & Spilker, 1999). Moreover, because of client advocacy, tax professionals may support client-favored tax positions, even when the tax position does not support the professional's own initial beliefs (Kahle & White, 2004). Together, these studies suggest that a tax professional will prefer a client-favored tax position due to their advocacy role.

Because of their knowledge of tax law it is suggested that preparers have two roles when providing tax services. Tax professionals will advocate for a client in ambiguous transactions, but they will enforce the correct treatment of a transaction in non-ambiguous transactions (Klepper & Nagin, 1989; Klepper, Mazur, & Nagin, 1991; Schisler, 1994). As a result, ambiguous tax issues will require tax professionals to use significant judgment concerning these issues when there is not substantial authority for the ambiguous tax issue (Johnson, 1993).

Ambiguity and the tax professional as client advocate have been studied in various forms throughout the literature. The more ambiguous a tax issue is the less confidence a tax professional would have at making judgments about that issue (Helleloid, 1989). Research suggests that ambiguity and a tax professional's recommendations may be influenced by certain factors. Ambiguity in a client's documentation for certain business expenses was found to have an effect on amounts tax preparers recommended (Helleloid), while Ayres et al. (1989) found that regulated tax professionals, such as CPAs, were more likely to offer pro-taxpayer advice than non-regulated tax professionals for ambiguous tax scenarios.

Barrick, Cloyd, and Spilker (2004) tested the influence of confirmation bias from staff-level accountants on the recommendations ultimately made by supervisors. Advocacy was one of the demographic variables used in the study, but it was found to be insignificant, indicating that advocacy did not have an impact on supervisor recommendations. Barrick et al. found that supervisors were more persuaded by a biased memo that incorrectly favored a client-preferred position than a biased memo that held the appropriate conclusion that the client-preferred position was incorrect. Newberry,

Reckers, and Wyndelts (1993) found that tax professionals, when faced with losing a client, were more likely to sign a tax return with a large deduction related to an ambiguous tax issue. Kaplan et al. (1988) found tax professional experience to be important regarding ambiguous tax issues. They found that less experienced professionals' recommendations for ambiguous tax issues were affected by the probability of an audit. However, Duncan et al. (1989) found that tax professionals were more likely to give aggressive recommendations to less aggressive taxpayers.

The decision environment also plays a role in the weighting of evidence for advocacy. Pinsker et al. (2009) find that the decision environment, whether it be audit or tax, moderates the influence of advocacy on recommendations, even when evidence is weighed disproportionally. Cuccia & McGill (2000) found that the role of advocacy in an ambiguous tax setting did influence a tax professional's recommendations, but the recommendations were not linked to the weighting of evidence.

Stephenson (2007) examined the difference between self-perception of client advocacy for tax preparers of local and regional firms and their clients' perception of that same advocacy. Stephenson found that tax preparers self-assess a higher level of advocacy at local and regional firms and a higher level than predicted by taxpayers that hire this type of tax professional. Stephenson also found that a typical taxpayer client base may not understand and may not desire the level of tax minimization efforts engaged in by tax professionals. The important insight from the study was if preparers are actually more aggressive than taxpayers prefer or conceive them to be, then preparers could give less aggressive advice, which would in turn reduce costs of providing services,

risks to the taxpayers, and gaps in taxes. This would help to realign the tax professionals' advocacy role in the tax system.

Barrick et al. (2004) propose that tax preparers seek to fulfill two objectives when recommending tax positions. These objectives are the accuracy objective and the advocacy objective. As a client advocate, tax professionals work to resolve tax issues and recommend appropriate positions when preparing tax returns for clients (Barrick et al). Tax professionals provide tax preparation services, but they also help taxpayers identify tax strategies that provide a reduction in tax liability (Dubin et al., 1992; Reinganum & Wilde, 1991).

Accounting professionals often attempt to please clients (Kadous, Magro, & Spilker, 2008), and they offer aggressive recommendations, particularly when these recommendations align with client preferences (Nelson, 2003), which is consistent with the role tax practitioners take as a client advocate (Cuccia et al., 1995; Johnson, 1993). Aggressive reporting is the result of a tax practitioner choosing a positive tax position when there is little support from the facts or guidance from the pertinent literature, such as substantial authority, for that tax position (Cuccia et al; Kaplan et al., 1988). Since client advocacy is a key component in the tax environment, tax professionals tend to prefer favorable client tax positions (Hatfield, 2000). Furthermore, research suggests that there is a positive relationship between tax professional recommendations and client preferences. From the perspective of client advocacy, tax professionals will recommend more (less) aggressive transactions for those clients that favor aggressive (conservative) transactions (Cloyd, 1995; Cuccia et al.; Schisler, 1994).

The construct of client advocacy has also been found to affect tax professionals' evaluation of information. When performing an informational search, a tax professional will most likely research past court cases and other administrative rulings that align with a specific tax transaction (Davis & Mason, 2003). Davis and Mason studied the effect of client advocacy and court case features. They found that tax professionals' role of advocacy did influence a tax professional's use of a court case as support for a tax position, but only for features common between the tax position and the court case. Johnson (1993) suggests that tax professionals place more relevance on authoritative information supporting a taxpayer's position than authoritative information that does not. Cuccia et al. (1995) also suggest that vague standards help tax practitioners to rationalize aggressive tax positions. Cloyd and Spilker (1999) found that tax professionals' search for information (judicial precedence) was most likely to be consistent with client favored tax positions, and that client preferences were found to influence a tax professional's information search that led to unsupportable tax positions. In addition, Hatfield (2001) suggests that tax professionals will give more weight to research reports that recommends a client-favored tax position than a research report that recommends a non-favorable client tax position.

Research suggests that the type of tax engagement effects how tax professionals will interpret ambiguous tax positions. Distinguishing between these is important when examining tax professionals' decision making because of the focus and levels of ambiguity within each type of engagement (Roberts, 1998). There are two primary types of tax engagements: compliance and planning. Both types of engagements work towards legally minimizing a client's tax liability, but a compliance engagement consists of

preparing and filing an accurate tax return, while a planning engagement consists of a tax professional consulting in an unstructured environment (DeZoort et al, 2012). Research suggests that tax professionals will interpret ambiguous tax positions more aggressively in compliance engagements than in planning engagements since they associate planning engagements with more complexity and risk (Magro, 1999; Spilker, Worsham, & Prawitt, 1999). As a result, tax professionals are more likely to assume an advocacy role rather than an advisory role in compliance settings (Robert, 1998).

Likewise, the professional and client relationship is evident in other accounting contexts, such that the loss of client is found to influence decision making in an auditing context (Blay, 2005; Farmer, Rittenberg, & Trompeter, 1987). Client preferences have also been found to influence auditor reports when information gathering is needed about an issue that is vague with limited guidance in the auditing standards (Blay). The literature indicates that accountants are willing to accept client preferences when audit issues arise, even if ambiguity exists (Hackenbrack & Nelson, 1996; Kadous, Kennedy, & Peecher, 2003).

Haynes et al. (1998) studied the client advocacy construct in an auditing environment. They performed a study to examine if the construct of client advocacy was present in auditors' recommendations regarding an important business transaction within the context of a corporate acquisition. The results of the study suggest that auditors did not function as a client advocate until client interests were introduced. In addition, client advocacy, when exhibited, was also positively influenced by years of audit experience, and auditors in national firms (non-national firms) gave more conservative (more aggressive) recommendations for the hypothetical business transaction.

Studies regarding tax advice have focused on the aggressiveness of the advice given in different scenarios. These studies have focused on aggressiveness and risk both from the viewpoint of tax professionals and taxpayers. In a study that focuses on the client-preparer relationship, Hite & McGill (1992) suggest taxpayers may purchase tax expertise and reporting aggressiveness as a package, but they would rather purchase only the tax expertise if it were available. The taxpayer may unwillingly assume more risk if there is not a clear understanding of the risk associated with an aggressive tax position (Cloyd & Spilker, 1999). Christensen (1992) finds that taxpayers may be less willing to assume risk related to aggressive tax positions than tax professionals. Duncan et al. (1989) found that tax preparers were more likely to give aggressive tax recommendations to the taxpayers with the lowest risk orientation, and tax preparers were more likely to recommend less aggressive positions to higher risk oriented taxpayers, which may suggest the intention of a tax professional to manage behaviors of their tax clients. Carnes, Harwood, and Sawyers (1996) studied the effects of tax preparer characteristics on aggressive recommendations in ambiguous tax scenarios and found that only risk propensity influenced the level of aggressiveness found in tax preparer recommendations. Kelliher, Bandy, and Judd (2001) found that when tax professionals were more familiar with professional standards, they gave less aggressive advice, particularly when there was minimal support for the client's preferred tax position.

Taxpayers have played a role in increasing the aggressiveness of a tax preparer's recommendations of tax positions. Christensen and Hite (1997) studied the effect of a taxpayer's risk propensity on reporting decisions and found that taxpayers were more aggressive for an ambiguous tax deduction item than for an ambiguous income item.

Interestingly, a taxpayer's payment position did not contribute to a tax professional's advice until the client's preferences for aggressive advice was introduced (Schisler, 1994). This suggests that taxpayers played a role in the recommendations given by the tax professional, and ultimately, the client/preparer relationship (Schisler, 1994). Similarly, Schisler (1995) found that taxpayers were more aggressive than preparers on the same scenarios presented in this study, which would suggest that clients may influence more aggressive tax positions in relation to the advocacy role.

Regulation of Tax Preparers.

Regulation has had an interesting impact on the tax professional's role of client advocate. Preparer sanctions have been found to influence recommendations from tax professionals for ambiguous tax issues (Newberry et al., 1993). Economic theory would suggest that regulation of tax preparers has allowed tax professionals' interpretation of the law to benefit the taxpayer, and it has also provided for the increased value of a tax preparer's advice to the client (Ayres et al., 1989). Furthermore, it is suggested that regulation, even if written with precision, will still provide the opportunity for a decision maker's intentions to line up with intended outcomes (Cuccia, Hackenbrack, & Nelson, 1995).

Regulation of tax preparers in relation to taxpayer compliance continues to be a present-day focus for the IRS. In 2007, Congress passed The Small Business Work Opportunity Act of 2007 that made significant changes to tax preparer penalties (Hansen & White, 2012). Changes involved increasing the penalty amount from $250 to $1,000 or more (based on a percentage of client fees), and it increased the reporting standards from which a preparer penalty could be imposed (Hansen & White, 2012). More recently,

the IRS has attempted to extend regulation to those tax preparers that are not enrolled agents, CPAs, or attorneys. These regulations would be in addition to the preparer penalties that have already been set forth. The intent of this new regulation was to develop ethical standards and to promote consistency throughout those standards, thereby increasing taxpayer compliance (CCH Tax News, 2011). The regulation program that the IRS set forth in 2011 would require all paid tax return preparers to register with the IRS using the Preparer Tax Identification Number (PTIN) program (Tolan, 2012). In addition to registering with the IRS, all paid preparers would be required to take a competency exam and meet mandatory competency training and education requirements (Tolan).

Interestingly, to date this new regulation program has been struck down by the courts (Nevius, 2013). According to a U.S. district court, requiring tax preparers that are not CPAs, enrolled agents, or attorneys to register with the PTIN program is beyond the statutory authority of the IRS (Nevius). However, the IRS is currently working to file a Notice of Appeal, anticipating that the regulation program, if not reinstated, could cause considerable harm to the public interest (Nevius).

Taxpayers' reliance on tax professionals prompted Congress to introduce a considerable number of preparer penalties for non-compliance (Collins, O'Neil, & Cathey, 1990). Because tax professionals have been an important third party in the relationship between taxpayer and the IRS, the IRS has also been shifting a portion of the monitoring on tax compliance to tax professionals (Duncan et al., 1989). This has been accomplished through subjecting tax professionals to preparation fees and other types of sanctions (Brody & Masselli, 1996; Duncan et al.).

Increased preparer penalties have had an interesting effect on tax preparers' aggressiveness on recommendations. Economic analysis would suggest that preparer penalties would help mitigate tax professionals' aggressiveness for tax recommendations, but research has shown otherwise (Cuccia, 1994). Cuccia found that aggressiveness was linked to accountant type (CPA or non-CPA) and the amount of effort spent identifying unambiguous items that reduced tax liabilities. Preparer penalties have also been found to be linked to the amount of risk a professional is willing to accept on a tax return. Reckers et al. (1991) found that if a risky tax position existed on a tax return, tax professionals were more likely to not sign the return. Likewise, in a later study, Hansen and White (2012) also found that because of increased preparer penalties (after changes in penalty provisions in 2007), tax professionals were less likely to sign a return that had an aggressive tax position. However, Hansen and White also found that increased preparer penalties did not have a significant effect on preparers recommending aggressive positions. This may be due to the influence the client advocacy construct has on tax preparers (Hansen & White, 2012).

Client Risk.

Some form of risk is inherent in accounting environments (Moreno, Kida, & Smith, 2002). It is essential for professionals, namely tax practitioners, to be consistent in adhering to professional standards and managing the risk that comes with incorrect conclusions and advice (Farmer et al., 1987; Nelson, 2003). For tax professionals, assessing client risk is especially important since claims against CPAs and the severity of the dollar amount of those claims are highest for tax engagements and expose the tax professional to regulatory sanctions from the IRS (Boyles & Feldman, 1988; Murray,

1992). The tax professional must learn to effectively manage client risk when developing client relationships (Fiore, 1998; Hill, 1998). Inherent in every client relationship is some level of risk, with a low risk client relationship being the ideal (Hill). Client risk is an important factor for tax practitioners to consider, especially in light of the increased amount of litigation against accounting professionals in the last two decades (Ferguson, 1996; Murray).

Client risk can influence a tax professional's advocacy toward a client (Bobek et al., 2010). Client risk represents the risk of certain costs associated with recommending inappropriate tax positions by the tax professional (Bobek et al.; Kadous and Magro, 2001). This type of risk has both monetary and nonmonetary costs which are the sole responsibility of the tax professional. If the advocacy role is fulfilled improperly, tax professionals face substantial costs (Davis & Mason, 2003). When inappropriate tax positions are taken, tax professionals face exposure to malpractice litigation, as well as monetary costs, such as preparer penalties assessed, additional amounts owed to the client due to interest and penalties, and legal fees; non-monetary costs include damage of reputation, sanctions imposed by various professional organizations and state boards of accountancy, and emotional burdens from criticism of work (Bandy, 1996; Boyles & Feldman, 1988; Ferguson, 1996; Fiore, 1998; Hill, 1998; Kadous and Magro; Schaefer & Zimmer, 1997). Damage of reputation as a non-monetary cost consists of both the damage to client relationships and relationships with fellow practitioners (Collins et al., 1990). In addition, there are costs associated with liability insurance to help manage risk, and tax firms are the most likely to purchase this type of coverage (Schaefer & Zimmer).

Client risk fluctuates, whether high or low in a given situation, depending on client characteristics (Fiore, 1998). For example, clients that exhibit characteristics such as risky or uncooperative behavior, an aggressive personality, questionable integrity, and weak records and accounting controls often represent a greater risk to a tax professional than clients that do not exhibit these characteristics (Bandy, 1996; Fiore; Hill, 1998; Murray, 1992). Client risk is also highest when clients exhibit other characteristics, such as fee pressures, financial difficulties, and involvement in risky industries or suspicious transactions (Bandy; Bobek et al., 2010; Murray). Another client characteristic, client importance, is found to influence tax professionals' willingness to accept risk. Reckers et al. (1991) found that as client importance, which was defined as the generation of both current and future cash flows for a firm, increased, tax professionals were also willing to accept more risk. In addition, client risk can be high when tax professionals make tax elections for their clients (Hill).

Studies, both in auditing and taxation, have shown that client risk can affect a tax professional's judgment when making recommendations. This relationship between client risk and aggressive reporting has been found in the auditing domain. Hackenbrack and Nelson (1996) studied engagement risk (which is similar to client risk in the tax setting) and an auditor's accounting reporting decision through an experimental design, with 90 participating auditors. They found that auditors were more likely to report an aggressive (non-aggressive) position when engagement risk was moderate to low (high). Studies have also examined this relationship in tax settings. Duncan et al. (1989) found that tax preparers were more likely to recommend aggressive tax positions to low-risk taxpayers and more likely to recommend less aggressive tax positions to high-risk

taxpayers. Using an experiment that involved 86 tax professionals, Kadous and Magro (2001) found that tax professionals placed different weights on information depending on the level of risk of the client. Specifically, the results of their study suggested that tax professionals were more likely to take an aggressive tax position for a low-risk client rather than a high-risk client. In addition, Kadous, Magro, and Spilker (2008) studied the effect of client risk on professionals' information search and recommendations. In their experiment, tax professionals were more likely to bias their information search and have aggressive recommendations when the client had low practice (client) risk.

Chapter 3 – Research Methodology and Design

Research Question, Hypotheses, and Expected Relationships

The current tax code in the United States (U.S.) is rather complex (Duncan et al., 1989; Jackson & Milliron, 1989). Due to this complexity, taxpayers will hire tax professionals to prepare tax returns each tax year. In 2003, over 60 percent of all tax returns filed were prepared by tax professionals (Guyton et al., 2005). Therefore, tax professionals provide an important role in the taxation system, by offering recommendations and assistance in tax return preparation. Tax professionals aid taxpayers with reporting complex, often ambiguous, tax transactions. S corporations can present challenging and ambiguous tax issues for taxpayers, such as determining reasonable compensation for officer-shareholders. The research question posed for this study is if there is a relationship between client advocacy, client risk, and the tax professional's recommended compensation amount of an S corporation officer-shareholder. Complete reviews of studies that contribute to this research question are provided in Chapter 2, but they are briefly summarized here for hypothesis development.

S corporation officer-shareholder compensation

The S corporation election is a unique one within the Internal Revenue Code (IRC). When an entity elects to be taxed as an S corporation, the entity is governed both by Subchapter C and Subchapter S of the IRC. If Subchapter S does not provide provisions for certain tax treatments, then the rules set forth in Subchapter C govern the S corporation. This causes the entity that has elected to be taxed as an S corporation to be unique. Many of the legal benefits and requirements of a C corporation pertain to S

corporations, but S corporations are taxed similar to partnerships, so income items from the S corporation flow through to a shareholder's individual tax return.

In an S corporation, officer-shareholders must be paid reasonable compensation for services rendered, even for minimal services provided. However, reasonable compensation values for these officer-shareholders are not defined in the IRC. As a result, tax professionals will make recommendations regarding compensation amounts for officer-shareholders based on numerous tax considerations (Fiore, 1990).

Determination of S corporation officer-shareholder compensation is an ambiguous tax issue since there are no absolute values for which reasonableness can be determined. Compensation must be determined based on a number of factors. Often times, tax professionals facilitate recommendations for officer-shareholder compensation, but these recommendations are often subjective. For closely-held S corporations, compensation amounts are primarily established based on tax considerations (Antognini, 2003). In addition, paying compensation or distributions is more likely to be an issue for closely-held corporations that have one shareholder or a few large shareholders (Fiore, 1990).

Studying compensation recommendations is a relevant topic, as officer-shareholders attempt to avoid certain payroll taxes by keeping compensation low. Furthermore, some S corporations choose not to compensate officer-shareholders to obtain considerable payroll tax savings, which is considered an aggressive tax position (Kirkland, 2013b). There is considerable risk for the taxpayer with this tax position, but the motivation is that the S corporation can pass profits to the shareholder at the shareholder's individual tax rate, without the shareholder paying additional payroll taxes. In summary, the lower the compensation of officer-shareholders who contribute

significant services to the corporation, the more aggressive the tax position becomes (Kirkland, 2013b).

Client Advocacy

In a tax setting, making decisions and recommendations can be somewhat unique from other settings since tax professionals may have conflicting roles when making tax positions recommendations. Many times, a tax professional may simultaneously function in the roles of being a client advocate (which is equivalent to supporting the client's preferred position) and maintaining accuracy (the likelihood of recommending an erroneous tax position) (Andre, 2010). Likewise, professional standards set forth by the American Institute of Certified Public Accountants (AICPA) also state that tax professionals have an obligation to the government, specifically the tax system. These conflicting roles can be especially problematic when dealing with ambiguous tax issues.

Ambiguity and client advocacy have been found to influence a tax professional's tax recommendations. Specifically, licensure, tax experience, and client importance have been found to affect a tax professional's advocacy for ambiguous tax positions. Concerning ambiguous tax positions, Certified Public Accountants (CPAs) are more likely to offer client-favored recommendations, while less-experienced tax professionals' recommendations were influenced by the possibility of an Internal Revenue Service (IRS) audit (Ayres et al., 1989; Kaplan et al., 1988). As for client importance, tax professionals were more likely to be aggressive with deductions concerning an ambiguous tax issue presented with the threat of losing the client (Newberry et al., 1993).

When making recommendations for clients, professional standards assert that tax professionals are to advocate for their clients, by researching, evaluating, and interpreting

tax law in favor of the client (Roberts, 1998). Taxpayers assume tax professionals will make recommendations in their best interest (Brody & Masselli, 1996), and tax professionals are expected to be an advocate for their clients (Cuccia & McGill, 2000). In the literature, client advocacy has been studied in relation to client preferences, such as what positions tax professionals will support based on client preferences. Tax professionals may not always objectively evaluate a client-favorable tax position when the position involves an ambiguous tax issue, and they may support this position despite the risk and lack of authoritative support associated with the tax position (Cloyd & Spilker, 1999).

Additionally, studies have examined client preferences in relation to recommendations (Cuccia et al., 2005; Johnson, 1993; Nelson, 2003). Research suggests that client preferences have an impact on the level of aggressive tax recommendations tax professionals are willing to propose. By examining the client advocacy construct, studies suggest that tax professionals will recommend more aggressive transactions for clients who favor aggressive transactions, while tax professionals will suggest less aggressive transactions for those clients that favor more conservative tax transactions (Brody & Masselli, 1996; Cloyd, 1995; Cuccia et al.; Schisler, 1994). In addition, aggressive taxpayers may influence more aggressive reporting for ambiguous tax positions (see Christensen & Hite, 1997; Schisler, 1994; Schisler, 1995).

From this comes the first research hypothesis:

H_A: Tax professionals will make more (less) aggressive recommendations for officer-shareholder compensation when exhibiting high (low) advocacy levels towards S corporation clients.

Client Risk

Client risk represents the cost associated with the tax profession recommending inappropriate tax positions (Bobek et al., 2010; Kadous & Magro, 2001). Client risk is an important construct to examine since some risk exists in all accounting environments, including tax settings (Moreno et al., 2002). Tax professionals must consider client risk and manage this risk when developing relationships with their clients (Fiore, 1998; Hill, 1998). There is some level of risk with any client relationship (Hill, 1998), but if risk is not identified and managed properly, the tax professional faces possible litigation and other intangible loss, such as damage to reputation (Collins et al., 1990).

The client characteristic of client risk plays an important role in tax professional recommendations (Duncan et al., 1989; Kadous & Magro, 2001; Kadous et al., 2008; Reckers et al., 1991). Client risk has been studied in the literature, and the amount of client risk associated with a particular client can vary (high or low) depending on the characteristics of that client (Fiore, 1998). Some examples of these client characteristics are uncooperative behavior, aggressive personalities, questionable integrity, weak accounting records, fee pressures, and financial difficulties (Bandy, 1996; Bobek et al., 2010; Fiore, 1998; Hill, 1998; Murray, 1992). In addition, when clients were considered important by tax professionals, the level of risk accepted by tax professionals increased (Reckers et al., 1991). Research suggests that for low (high) levels of client risk, tax professionals will recommend aggressive (non-aggressive) tax positions (Duncan et al, 1989; Hackenbrack & Nelson, 1996; Kadous & Magro, 2001; Kadous et al., 2008).

From this comes the second research hypothesis:

H_B: Tax professionals will make more (less) aggressive recommendations for officer-shareholder compensation for S corporation clients considered low (high) risk.

Based on the literature review and the research hypotheses, the expected relationships of client advocacy, client risk, and officer-shareholder compensation are summarized in Table 1.

Table 1

Expected relationships between client advocacy, client risk, and compensation recommendations

	Client Advocacy (Loyalty)	
Client Risk	**High**	**Low**
High	Lower Compensation	Highest Compensation
Low	Lowest Compensation	Higher Compensation

Research Design

The purpose of this study is to examine whether there is a relationship between client risk and client advocacy on a tax professional's recommendation for compensation of an officer-shareholder of an S corporation. The recommendation that a tax professional made for compensation consists of an actual dollar amount, which makes the dependent variable (recommendation) a matter of valuation. Since this study has a dependent variable of valuation and seeks to examine if there is a relationship between the dependent variable and independent variables, regression analysis is the appropriate statistical tool (see Porcano, 1982). Regression analysis has also been used previously to determine reasonable compensation and to identify factors associated with reasonable compensation (Porcano, 1982). Thus, multiple regression analysis will be used to assess

the relationship between the independent variables, or client advocacy and risk, and a tax professional's officer-shareholder compensation recommendations.

The regression model that has been developed based on the literature will examine if there is a relationship between client advocacy, client risk, and a tax professional's recommendation of a dollar amount for compensation of an S corporation officer-shareholder. The dependent variable is the dollar amount of the tax professional's recommendation of compensation of an S-corporation officer-shareholder. Client risk and client advocacy are the independent variables. Included in this model are certain demographic variables, such as years of experience, firm type, title of tax professional, gender, education of tax professional, and license of tax professional. Company size, company revenue (sales), company net income, and company return on equity (ROE) will serve as control variables. Demographic variables will be collected by the survey instrument.

To test this model, a survey instrument was administered that contained a case scenario with certain information regarding S Corporations in a between-subjects experimental design. The tax case scenario was designed to manipulate the independent variable, client risk, in a high and low condition,[29] measure the independent variable, client advocacy, and control for certain client characteristics.[30] The case scenario consisted of a tax vignette with certain client characteristic descriptions that tax preparers

[29] In each condition, the descriptions of the hypothetical client served as the manipulation. In the low risk condition, the client was described as being cooperative, avoiding tax saving strategies, having strong documentation and records, and having no previous IRS audits. In the high risk condition, the client was described as being uncooperative, suggesting tax saving strategies whenever possible, having incomplete financial records, and having previous IRS audits which resulted in sizable penalties and interest.

[30] The hypothetical client was described as having a company that has elected S corporation status for the tax year in question, with a sole shareholder. The shareholder performs all duties of the company, and works at least 40 hours per week to perform all duties.

utilized to make a recommendation regarding compensation of an officer-shareholder of an S Corporation based on the facts and information presented.

Participants were randomly assigned to one of two possible case scenarios that detailed the tax issues surrounding S corporation shareholder compensation. In addition, the appropriate relevant IRS guidance was provided on this tax issue. Certain characteristics of the S corporation were controlled for in the case scenarios. The manipulation of certain client facts were presented within the tax case scenarios.

The survey instrument for this study was web-based. According to Couper (2000), there are different web-based typologies. This study employed a list-based, probability survey (Couper). It is important to identify the type of web-based survey used since there are distinct issues associated with web surveys. The issues associated with web surveys are coverage rate, nonresponse rate, and measurement error.

The issue of coverage rate exists due to the lack of all sampling participants not having access to the internet or a computer (Couper, 2000). However, for this study, coverage rate was high, as this study sought to survey tax professionals who have access to a computer and the internet, because of the nature of their work.

Nonresponse rates are also an issue with web-based surveys. This study obtained a listing of tax professionals from a United States (U.S.) state Certified Public Accountant (CPA) society that were eligible to participate. By having a list of possible participants, it was possible to measure the nonresponse rate.

Because web-surveys are self-administered, measurement error can be a concern. To overcome measurement error, the survey was designed to be responder-friendly to mitigate potential errors commonly found in surveys (Dillman, Tortora, & Bowker,

1998). The definition of a responder-friendly design is the "construction of web questionnaires in a manner that increases the likelihood that sampled individuals will respond to the survey request, and that they will do so accurately, i.e., by answering each question in the manner intended by the surveyor," (Dillman et al., p. 3). To ensure a responder-friendly design, a pre-testing of the survey instrument was conducted. More about the pre-test will be discussed in the section titled, "Data collection". The design of the survey instrument followed guidelines established for web-based surveys (see Couper, Traugott, & Lamias, 2001). In addition, the survey had a welcome screen with brief instructions for completing the instrument. Throughout the survey, the participant was given instructions on how to proceed through the survey and estimates for completing the instrument. This facilitates motivation and ease of completion on the part of the participant (Dillman et al.).

Variables

In this study, two types of variables were used: a dependent variable representing the recommended amount of compensation for an S corporation officer-shareholder, and independent variables (client risk and client advocacy). Demographic variables[31] were included in the regression equation to improve the results of this study. Furthermore, other independent variables, or company-specific variables,[32] were incorporated into this study because of the likely impact they have with compensation recommendations. Each type of variable and its role in this study is discussed in detail below.

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[31] Demographic variables that were collected in the survey were years of tax experience, firm type, title within the firm, gender, education level, and professional status.

[32] Company-specific variables in this study were company size, company revenue (sales), company accounting net income, and company return on equity (ROE).

Dependent variable

The dependent variable in this study is the recommendation amount for an S corporation officer-shareholder's compensation, which is a continuous variable. Participants were asked to give a dollar amount as a recommendation for the hypothetical client (who is an officer-shareholder in an S corporation).

A recommendation in a dollar amount, instead of a formula recommendation, was used. This is due to tax professionals having to advise on an actual amount in practice when asked to make a recommendation for compensation for S corporation officer-shareholders. Formulas may be used to aid in the calculation, but ultimately, a dollar value should be established. For example, one approach developed by tax professionals that has been used is the 60-40 approach, where 60% of total payments to an officer-shareholder are considered salary and the other 40% are distributions (see Fellows & Jewell, 2007).

Independent variables

Client Advocacy

Client advocacy, one of the independent variables in this study, was a measured variable, and was evaluated using an advocacy scale first developed by Mason and Levy (2001) [see Appendix A for the items in the advocacy scale]. This advocacy scale measures a tax professional's loyalty to the client, and it has been used in numerous studies to measure the extent of a tax professional's client advocacy (see Barrick et al., 2004; Bobek et al., 2010; Davis & Mason, 2003; Kadous & Magro, 2001; Kahle & White, 2004; Pinsker et al., 2009; Stephenson, 2007).

Currently, there are not many scales that measure tax professionals' advocacy levels. An early advocacy scale was developed by Johnson (1993). This was a 17-item scale that measured a tax professional's level of advocacy as it relates to interpretations of judicial authority. This scale was subsequently used in a study that examined tax professionals' beliefs and interpretations of authority when the tax law is ambiguous (see Cuccia & McGill, 2000).

Almost a decade later, Mason and Levy (2001) developed a nine-item advocacy scale, which measures advocacy attitudes of tax professionals, rather than interpretations of authority. The advocacy scale developed by Mason and Levy (2001) has been widely used in a number of tax-related studies, contributing to the scale's validity (see Barrick et al., 2004; Bobek et al., 2010; Davis & Mason, 2003; Kadous & Magro, 2001; Kahle & White, 2004; Pinsker et al., 2009; Stephenson, 2007).

The Mason and Levy (2001) advocacy scale was selected for this study for two reasons. First, it was selected for its reliability. This scale has been tested for reliability in past studies, revealing high scores using Cronbach's alpha. A summary of these studies can be found in Table 2. A Cronbach's alpha > 0.70 is considered acceptable in most social science studies (see Cortina, 1993). Second, this study seeks to measure a tax professional's advocacy attitude, specifically relating to a hypothetical client. Advocacy is considered to be a mind-set of the tax professional, and it has been used in studies to measure this mind-set (see Bobek et al., 2010; Roberts, 1998 for further review). As a result, this scale was selected to measure the link between the tax professionals' advocacy levels and a specific, hypothetical client (see Bobek et al., 2010).

Table 2

Reliabilities of Advocacy Scale in Prior Studies

Scale	Study	Participants	Reliability
1 Advocacy Scale (general)	Mason & Levy 2001	34 tax CPAs and 30 IRS agents	Cronbach's alpha = 0.83
2 Advocacy Scale (general)	Davis & Mason 2003	91 tax CPAs and 59 IRS agents	Cronbach's alpha = 0.88
3 Advocacy Scale (general) Advocacy Scale (client-specific)	Bobek et al 2010	93 tax professionals	Cronbach's alpha = 0.81 Cronbach's alpha = 0.84
4 Advocacy scale (general - 5 items)	Pinsker et al 2009	44 auditors, 38 tax professionals, and 80 masters' students	Cronbach's alpha = 0.85

In this study, client-specific advocacy, rather than general advocacy, was measured. Bobek et al. (2010) found that client-specific advocacy prompted a tax professional's recommendations given an ambiguous tax scenario. Specifically, their study found that client risk motivated the tax professional's advocacy toward a client (thus, client-specific advocacy). This client-specific advocacy was then found to influence a tax professional's recommendations. Therefore, the current study focused on measuring client-specific advocacy and its relationship to client risk and a tax professional's recommendation of compensation for an S corporation officer-shareholder.

Client-specific advocacy was examined in this study. This was accomplished by replacing "the taxpayer" in each of the items in the advocacy scale from Mason and Levy (2001) with the hypothetical taxpayer's name. This process was used by Bobek et al. (2010) to capture client-specific advocacy.

To measure client-specific advocacy levels, the participant was asked to respond to the nine items on the advocacy scale after reading the case scenario and giving their recommendation for a compensation amount. This allowed the assessment of attitudes of client-specific advocacy from the participants since they were introduced to the

hypothetical client within the experiment (and the names of the hypothetical client were inserted in place of "taxpayer" in the advocacy scale's nine items). This procedure followed the same procedure that Bobek et al. (2010) used to measure client-specific advocacy. Participants were asked to respond to the nine questions in the advocacy scale based on a seven-point scale, ranging from "strongly disagree" to "strongly agree."

The literature suggests that tax professionals will make more aggressive recommendations when they exhibit higher levels of client advocacy, especially when handling ambiguous tax transactions (Brody & Masselli; Christensen & Hite, 1997; Cloyd, 1995; Cuccia et al.; Schisler, 1994; Schisler, 1995). For S corporations, the lower the compensation amount (all other things equal), the more aggressive the tax position becomes (Kirkland, 2013b). It is expected that with higher levels of client advocacy, there will be a lower amount of compensation recommended, which causes the expected sign for the variable coefficient to be negative.

Consistent with Bobek et al. (2010), client advocacy was a continuous variable. This variable was measured by summing the scores from the nine statements in the advocacy scale. Participants were asked to rank each statement based on a seven-point scale, ranging from "strongly disagree" to "strongly agree." Therefore, the minimum score possible was a 9, while the maximum score possible was 63 (see Davis & Mason, 2003; Mason & Levy, 2001; Pinsker et al., 2009).

Client Risk

Client risk can be high or low in a given scenario, based on certain client characteristics (Fiore, 1998). The independent variable, client risk, was manipulated in a between-subjects design, with two experimental conditions in the study. Client risk was

either high or low based on the manipulation of certain client facts. The client facts were based on descriptions of risky clients from the literature and risk manipulations of client characteristics found in previous studies (see Bobek et al., 2010; Kadous & Magro, 2001).

In the manipulation for high client risk, the hypothetical client had weak financial records and was uncooperative, suggested tax saving strategies often, and had previous IRS audits resulting in substantial penalties and adjustments. In the manipulation for low client risk, the hypothetical client had strong financial records, avoided tax saving strategies, and never had an IRS audit. These manipulations were also the operationalization of client risk. Other studies have used similar descriptions to operationalize client risk (see Bobek et al., 2010; Cloyd, 1995; Cuccia et al., 1995; Duncan et al. 1989; Helleloid, 1989; Kadous & Magro, 2001; Kadous et al., 2008; Roberts, 1998; Schisler, 1994). Finally, the client risk manipulations in this study related to client characteristics and not environmental factors, which is the emphasis of past client risk studies (see Kadous & Magro, 2001).

To evaluate the degree of client risk manipulation, participants were also asked to rate how much risk was created to maintain the hypothetical tax client in relation to other clients at their respective firms. The rating for this measurement was 1 (no risk) to 7 (very high risk) (see Bobek et al., 2010). Descriptive statistics of these responses were analyzed to determine if the manipulations were effective.

Studies suggest that when client risk is present, especially high levels of client risk, tax professionals will be inclined to recommend less aggressive tax positions (Duncan et al, 1989; Hackenbrack & Nelson, 1996; Kadous & Magro, 2001; Kadous et

al., 2008). These studies also suggest that when client risk levels are low, tax professionals have a tendency to recommend more aggressive positions (see Duncan et al, 1989; Hackenbrack & Nelson, 1996; Kadous & Magro, 2001; Kadous et al., 2008). The lower the compensation, the more aggressive the transaction becomes for S corporation officer-shareholders. Therefore, client risk and compensation were expected to have a positive relationship.

In the model, client risk was a binary variable, as there were only two possible outcomes, high client risk and low client risk[33] (see Bobek et al., 2010; Kadous & Magro, 2001). These possible outcomes were derived from the descriptions of client characteristics found in the hypothetical client vignette (see Bobek et al., 2010; Duncan et al., 1989; Kadous & Magro, 2001; Roberts, 1998). Client risk was coded as a binary variable, using the coding 1, 0.

Demographic variables

The demographics collected included years of tax experience, firm type, title within the firm, gender, education level, and professional status. These preparer characteristics were relevant to this study, as they have been used in prior studies that examine tax preparer aggressiveness in ambiguous tax scenarios and client advocacy (see

[33] These outcomes will be predetermined based on which vignette the participant will receive at the time of the survey. Because of the design of the survey (since it was web-based), the only effective way to ensure that there were participants in each experimental condition was to have them respond to one or the other based on last name. Therefore, each participant was randomly assigned to each condition by last name. See Table 5 showing demographic information for each experimental condition (high risk and low risk). This is a limitation of the study, in that, the participant will not receive both surveys with both descriptions as a comparison. As a result, future research could consider conducting the survey as a comparison of both the high and low risk outcomes simultaneously.

Ayres et al., 1989; Bobek et al., 2010; Carnes et al., 1996; Kadous & Magro, 2001; Kadous et al., 2008; Kelliher et al., 2001; McGill, 1988; Roberts, 1998).

Prior research has indicated that years of tax experience can explain significant differences in tax professionals' reporting recommendations (Roberts, 1998). The results have been mixed, most likely the result of how this variable was operationalized in the studies (Carnes et al., 1996; Roberts, 1998). However, there are studies that have found a link between experience and aggressive reporting. More experienced tax professionals may be more likely to recommend more aggressive recommendations (Helleloid, 1989; McGill, 1988). Research also shows that there is a difference between recommendations made from tax professionals with different years of experience when influenced by the client's position (Lowe, Reckers, & Wyndelts, 1993). Experience is an important variable when making recommendations in ambiguous tax settings since tax professionals rely on an accumulation of knowledge to make such decisions (Kaplan et al., 1988). As a result, this variable impacted the results of this model. It was expected that participants with more experience would recommend lower compensation amounts since a lower compensation amount is hypothesized as a more aggressive recommendation.

Consistent with prior research, years of experience was a continuous variable, and it was measured in number of years (see Bonner et al., 1992; Davis & Mason, 2003; Helleloid, 1989; Newberry et al., 1993). Participants were asked to provide the number of years of experience they have on the survey instrument.

There are different firm types that employ tax professionals, such as local, regional, or national firms. Prior research indicates that there is a difference in reporting recommendations among CPAs within different types of firms (Carnes et al., 1996;

Roberts, 1998). Firm type may also affect a tax professional's recommendations and whether those recommendations are aggressive (see Stephenson, 2007). Research also suggests that attitudes among CPAs are different across different-sized firms (Cuccia, 1995), and tax professionals' judgment decisions are different across various firm types (Helleloid, 1989). CPAs from national firms may be more aggressive than CPAs that work at local or regional firms (Stephenson, 2007). This was expected to impact the model in this study, such that tax professionals from national firms may recommend lower compensation amounts than professionals from other firms.

Firm type was a discrete variable since the data was non-order specific and categorical. The data for this variable was captured in 3 different classifications,[34] ranging from a local firm to a national firm. This required two binary (dummy) variables in the model. Consistent with prior research, the three different classifications were local, regional, and national/Big 4 (see Bobek et al., 2010; Helleloid, 1989; Karlinsky & Koch, 1987). Since complete definitions were not given in past research, definitions were derived using elements from past research and the author's understanding of firm classifications. Local firms were defined as those firms with less than 50 employees and one office. Regional firms were defined as those firms with more than 50 employees and 5 or more offices. National firms were defined as Big 4 firms.

Public accounting firms are staffed with higher-level accountants (such as supervisors, managers, and partners) and lower-level accountants (staff accountants). The title that a tax professional holds may influence recommendations, except that

[34] The data were captured in 3 different classifications [local firm, regional firm, and national (Big 4) firm]. The intent was to capture this variable using 4 classifications (local, regional, national, and international firm), but there was insufficient response rates for the 4th classification (international firm).

research shows when ranking tax authorities, title in the firm was not significant (Chow, Shields, & Whittenburg, 1989). The hierarchy in public accounting firms provides that higher-level accountants review the work of lower-level accountants, and much of the initial research in firms is performed by lower-level accountants (Barrick et al., 2004). Lower-level accountants' decisions may also be prone to bias (Rich, Solomon, & Trotman, 1997; Roberts 1998). Hatfield (2001) suggests that higher-level accountants are able to recognize a potentially biased research recommendation made by a lower-level accountant, but higher-level accountants placed more weight on research reports that were client-favored. Barrick et al. (2004) found that supervisors may be more likely to meet the advocacy objective for recommendations when the accuracy objective is not met. Therefore, it was expected that higher-level accountants in this study would be more likely to recommend a lower compensation amount, as this is consistent with a client-favored (advocacy) position.

The title variable was ordinal. Participants were able to choose from six different titles that are common in accounting firms and have been used in past research (see Bobek et al., 2010; Chow et al., 1989; Karlinsky & Koch, 1987). With six different titles, there were five binary (dummy) variables required in the model.

Gender as a variable was captured in this study. Prior research has shown that there are differences in gender and risk aversion, and therefore, is an important variable to control for (Kelliher et al., 2001; Roberts, 1998; Sanders & Wyndelts, 1989). Males are inclined to be less risk-averse than females (Byrnes, Miller, & Schafer, 1999). Furthermore, tax studies have also studied gender as it relates to tax professionals' recommendations. In their study regarding client advocacy, Bobek et al. (2010) found

that males were more likely to recommend a client-favorable tax position. McGill (1988) and Sanders and Wyndelts (1989) found that females were less likely to make an aggressive recommendation than males. Therefore, it was expected that male tax professionals would make more aggressive and client-favored recommendations, by recommending lower compensation amounts.

Gender was a binary variable since data was limited to two categories (male or female). It was coded as 1, 0 (see Carnes et al., 1996; Roberts, 1998).

Education level is also associated with differences in reporting decisions by tax professionals (Bonner et al., 1992; Karlinsky & Koch, 1987). Specifically, the degree earned by the tax professional was a significant variable in explaining differences in reading comprehension (Karlinsky & Koch, 1987). Formal training in taxation has also been shown to be significant with tax transaction knowledge (Bonner et al., 1992). There is also evidence to suggest that more aggressive recommendations are linked to having more formal education (Carnes et al., 1996). Therefore, education could impact the recommendation of compensation in this study. The more formal education a participant has had, it was expected that the recommendation for compensation amount will be lower.

Education was measured in type of degree earned by the participant, which is consistent with past studies (see Carnes et al., 1996; Karlinsky & Koch, 1987). This variable was ordinal, because data was captured in order-specific groupings. Three

education classifications were used, which required two binary (dummy) variables in the model.[35]

Professional status has been studied regarding a tax preparer's decision making. Specifically, CPAs recommendations have been found to be more pro-taxpayer and to advocate for the taxpayer than recommendations made by non-CPAs (Ayres et al., 1989). In this study, it was posited that there is a direct relationship between advocacy levels and aggressive recommendations. Therefore, professional status is important, as this study examined client advocacy on compensation recommendations. It is was expected then that a CPA would recommend lower compensation amounts than a non-CPA.

Licensure was captured using two different categories, making this a binary variable. Participants had the option of choosing if they are a CPA or not a CPA. Licensure as a binary variable is consistent with past studies (see Ayres et al., 1989; Bobek et al., 2010; Karlinsky & Koch, 1987; Stephenson, 2007). For those participants who identified themselves as a "CPA", they were able to indicate if the license was active or inactive. For those participants who identified themselves as "not a CPA," there were four choices, ranging from already passed exam but not certified to having another licensure besides the CPA. The variable was coded as 1, 0.

Company-specific variables

Other factors may impact the dollar amount of compensation for an officer-shareholder, and thus, may interact with compensation recommendations. Control

[35] The data were captured in 3 different classifications (bachelor's degree, master's degree, and doctorate degree). The intent was to capture this variable using 5 classifications (no degree, high school degree, bachelor's degree, master's degree, and doctorate degree), but there was insufficient response rates for the "no degree" and "high school degree" classifications.

variables were included in this study to control for this potential impact and are discussed below. To control for these variables, they were integrated into the tax case scenario.

Company size is an important variable in relation to compensation. The literature suggests that there is a relationship between compensation and company size (Jensen & Murphy, 1990; Wang, Venezia, & Lou, 2013), as compensation is more sensitive with smaller companies than with larger companies (Jensen & Murphy; Watts & Zimmerman, 1978). Changes in compensation are also more sensitive in owner-controlled companies than in management-controlled companies (Tosi, Werner, Katz, & Gomez-Mejia, 2000). Including company size in the analysis assisted in controlling for this effect. Total assets was used as a proxy for company size (Wang et al.).

Total assets was used as a proxy for the control variable, company size, so that the more total assets a company has, the larger the company. Company size and compensation have been shown to have a positive relationship (Cyert, Kang, & Kumar, 2002; Wang et al., 2013). Specifically, officers in larger companies have higher compensation than officers in smaller companies.

It has been found that accounting measures are positively associated with compensation (Wang et al., 2013). Company revenue, company net income, and return on equity (ROE) are accounting measures that may have an impact on compensation recommendations. When companies are able to generate more revenues, and ultimately net income, they are able to pay management more compensation. ROE serves as a proxy for possible conflicts of interest between shareholders and management (see *Elliotts vs Comm'r*, 1983). These variables are discussed in detail below.

Company revenue (sales), is an important control variable because of the inherent differences between larger and smaller companies. As a result, larger companies are able to generate revenues from broader client bases, while smaller companies may rely on a few clients to generate revenue (see Haynes et al., 1998). Moreover, companies with higher sales volumes have the ability to compensate high-level managers more than companies with smaller sales volume (Wang et al., 2013).

Likewise, the company's accounting net income was a control variable. For many companies, compensation plans contain accounting net income as a measurement component (Watts & Zimmerman, 1978). In addition, accounting measures, such as accounting net income, are increasingly used over market-based measures in determining compensation (Wang et al., 2013).

Return on Equity (ROE) is also an accounting based measure. Generally, it is used as a performance or profitability measure (Wang et al., 2013). For this study, ROE served as a proxy for possible conflicts of interest between shareholders and management (see *Elliotts vs Comm'r*, 1983), and was calculated as net income divided by shareholder's equity. This ratio measures the return on investment for shareholders in a company; generally, the higher the ratio is, the higher the return on investment. ROE can have an impact on compensation, because there is a continuous trade-off between the goals of management and the goals of shareholders inherently present within companies (Jensen & Murphy, 1990).

Regression Model

Prior research has used regression analysis to examine a number of tax-related issues, such as when taxpayers purchase tax advice (Beck et al., 1996); tax professionals'

search for information (Cloyd & Spilker, 1999); and evaluation of a tax professional's responsibility for tax fraud detection (DeZoort et al., 2012). Regression analysis has also been used to investigate client advocacy within an auditing context (Haynes et al., 1998). Studies have also utilized regression analysis to examine components of compensation, investigate determinants of reasonable compensation, and evaluate the relationship between compensation and shareholder wealth (see Cyert et al., 2012; Jensen & Murphy, 1990; Porcano, 1982).

Bobek et al. (2010) used path analysis and regression analysis to study client advocacy and client characteristics, such as client risk, on a tax professional's recommendations on an ambiguous tax issue. Following their approach, a multiple regression model was developed for examining the relationship between the recommendation for compensation of an S corporation officer-shareholder and the independent variables, client risk and client advocacy. The regression model and the expected signs (whether positive or negative) for each variable are given below.

$$COMP = \beta_0 - \beta_1(ADV) + \beta_2(RISK) + \beta_3(EXP) + \beta_4(FIRM) + \beta_5(TITLE) + \beta_6(GENDER) + \beta_7(EDUC) + \beta_8(CPA) \quad (3.1)$$

Where:

COMP= represents the dependent variable, the recommended dollar amount of compensation of the shareholder of an S corporation

ADV = the independent variable, client advocacy

RISK = the independent variable, client risk

EXP = number of years of experience for the tax professional, a demographic variable

FIRM = firm type, a demographic variable

TITLE = tax professional's title in a firm, a demographic variable

GENDER = male or female, a demographic variable, which will be coded as the value of one if male, and zero if female

EDUC = level of education of tax professional, a demographic variable

CPA = the license a tax professional holds, a demographic variable

Data Collection

Sample

Tax professionals that are members from a United States (U.S.) state society of CPAs were asked to participate in the study, and it was conducted during a non-tax season timeframe. Conducting the survey during a non-tax season period was chosen specifically to encourage participation from tax professionals, who would otherwise not have the availability to participate in such a survey. The proposed sample size was 97

participants.[36] The sample size for similar type studies in the tax literature vary. Tax professionals responded to the vignettes online by using an online survey website, which was Survey Monkey, during a set time-frame. The survey was opened for two and a half weeks for participants to complete. To also encourage participation in the survey, participants were offered the opportunity to win one of four $25 gift cards once the survey was complete.

Procedure

To ensure that the case scenario used in this study is as realistic as possible, this survey instrument was pre-tested. The survey materials were also examined by tax professionals, who were able to give advice as to whether the final materials were as realistic as possible in an experimental design (see Kahle & White, 2004). The final case scenario was then used in the survey and distributed to participants. Participants were randomly assigned to one of two experimental conditions (high risk or low risk). The research instrument began with the case scenario, which included the tax vignette and client details. Participants were instructed to read this vignette and the corresponding client facts and make a compensation recommendation for an officer-shareholder in an S corporation. Following this recommendation, participants were then asked to respond to the advocacy questionnaire. Lastly, participants were asked questions at the end regarding certain demographic information.

[36] The sample size for this study was calculated to be 97 using criteria from Israel (2014). When determining sample size, level of precision, level of confidence, and degree of variability must be determined. These criteria were used to calculate the proposed sample size, using a 10% level of precision and a 95% level of confidence (Israel, 2014).

Pilot study

A pilot test of the complete survey instrument was conducted to ensure understanding from participants. The participants for the pilot test were selected because of their similarities to the actual research participant sample. Pilot study participants were CPAs and non-CPAs working in a variety of accounting fields, such as public accounting, industry, and education. For the pilot test, there were 29 participants who took part in the pilot survey. Initially, these respondents were contacted as a result of personal contacts.

Respondents provided feedback on several areas of the survey instrument, and from this feedback, minor changes were made to the survey instrument. First, respondents indicated that the time to complete the survey was 15-20 minutes rather than the initial estimate of 15-30 minutes that was part of the introduction to the survey. This change was then made to the actual survey instrument. Second, participants provided feedback on the understandability of the survey instrument. All participants indicated they were able to follow and understand the tax case and questions. However, one respondent indicated that the demographics were difficult to answer because they were not currently practicing in public accounting. The demographic questions were modified to encompass all areas of accounting based on this feedback.

In addition to general feedback about the survey, a few respondents offered personal observations about the tax case. In summary, the feedback received indicated that the participants understood what was being asked of them, and it also suggested that the survey instrument was thought-provoking within the context of this study. Therefore,

no changes were made to the tax case scenario or to the advocacy scale measurement due to minor suggestions and prior scale validation.

Administration of survey instrument

Data collection began in December 2015, once approval was obtained from the Human Subjects Committee (see appendix D for letter of approval). Surveys were sent electronically through email addresses from a state society of CPAs in the United States (U.S.). The body of the welcome message to possible participants was drafted. It was then sent out through a senior manager of the state society in member relations.

The initial survey email was sent to participants on December 2, 2015 (for a review of this communication, see appendix E). The email message gave details about the survey and research study, including what the research was, how the results would be used, participant anonymity, a time frame to respond, and the link to the survey. A follow-up email was not sent due to time constraints and circumstances that were beyond my control. The survey closed at midnight on December 18, 2015.

Data Analysis

The relationships in this model were estimated used regression analysis, and the statistical significance of the model was tested using the F-stat. Regression analysis was used since it is a technique that permits a continuous dependent variable and independent variables that may be continuous or categorical. The dependent variable was the dollar amount of the recommendation of compensation of the S corporation shareholder by the tax professional. The independent variables were client risk and client advocacy. In addition, demographic variables were years of experience, firm type, title of the tax professional, gender, education of tax professional, and license of the tax professional.

Control variables were company size, company revenues, company net income, and ROE. Raw data were analyzed using the statistical software, Minitab. In addition, descriptive statistics were measured on the demographic variables. Additional analyses concerning the control variables were added for improving the understanding of the results of this study.

Chapter 4 – Data Analysis and Research Results

The intent of this research was to examine the relationship of client risk and client advocacy to a tax preparer's recommendation of the compensation of an officer-shareholder in an S corporation. For purposes of this study, client risk is defined as the monetary and nonmonetary costs a tax professional bears from drawing erroneous conclusions or recommendations. The cost of this risk is both monetary and nonmonetary[37] to the tax professional. Client advocacy is defined as a state of mind where the tax professional demonstrates loyalty to a client through representing the taxpayer within legal boundaries (see AICPA, 2010; Mason & Levy, 2001).

Tax professionals provide an important service, by making recommendations to ambiguous tax transactions. Advocacy is an important component of professional standards (see Roberts, 1998), and past research has shown that, client advocacy and ambiguity influence a tax professional's tax recommendations, particularly when studied in relation to certain professional demographics. Client risk has been examined in past studies through client characteristics, and research shows that depending on whether the assessed level of risk is lower (or higher), professionals will recommend more (or less) aggressive tax positions. Therefore, to better understand the constructs of client advocacy and client risk as they relate to compensation recommendations (an ambiguous tax issue), this study uses an advocacy scale to measure a tax professional's advocacy towards a client, dependent on the level of risk associated with a client. To study the

[37] A tax professional must manage both monetary and nonmonetary costs associated with making an erroneous recommendation. Monetary costs might be legal fees, preparer penalties, and additional amounts owed to the client due to interest and penalties, while nonmonetary costs might be exposure to malpractice litigation, damages to reputation, sanctions imposed by professional organizations and accountancy boards, and emotional burdens associated with criticism of work (see Bandy, 1996; Boyles and Feldman, 1988; Ferguson, 1996; Fiore, 1998; Hill, 1998; Kadous & Magro, 2001; Schaefer & Zimmer, 1997).

Table 3

Study Participants	
Total respondents to survey instrument	909
Respondents removed from study due to:	
Not finishing survey instrument	309
Missing responses or unintelligible responses for the dependent variable, compensation	96
Lacking tax experience	276
Belonging to demographic categories that contained only one response	2
Missing responses for items regarding independent variables	6
Reponses for dependent variable considered outliers	10
Final Sample	210 Participants

research question, a survey instrument was created and responses were obtained from tax professionals from a state society of Certified Public Accountants (CPAs).

Each participant was sent an email stating the purpose of the research, its importance, and a link to the survey. Table 3 shows the final sample of participants used in this study. In total, 909 accountants responded to the survey. Of the 909 who responded to this survey, 309 participants did not finish the survey. The sample group was then reduced by 96 since these participants had missing responses or unintelligible responses for the dependent variable, compensation. Since this research seeks to examine client advocacy and client risk for tax professionals, an additional 276 participants were excluded due to their lack of tax experience.[38] Additionally, two participants were in demographic categories that contained only one response. Six responses were also removed due to missing responses for items relating to the independent variables and demographic variables. Finally, the sample was reduced by ten since these responses

[38] For this study, "lack of tax experience" was defined as those participants that did not have any tax experience.

were considered outliers for the dependent variable.[39] The final sample used for all analyses consists of 210 tax professionals.[40]

This chapter summarizes the results of this research, and is organized into three sections. The first section reports demographic information of the participants and descriptive statistics of the survey data. The second section reports the results of the research model and the research hypotheses. Lastly, the third section reports additional statistical analyses.

Participant Demographics and Descriptive Statistics

Client risk, which was one of the independent variables used in this research, can be high or low in a given scenario by having certain client characteristics present. This independent variable was manipulated in a between-subjects design, with two experimental conditions – low risk and high risk. Participants were designated to one of the experimental conditions by last name, with 66 percent of participants in the low risk condition and 34 percent in the high risk condition.

Participants were asked to respond to a number of demographic questions at the end of the survey. A summary of descriptive statistics for the dependent variable and independent variables (except client risk) is

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[39] Outliers are data points that are "unusually small or unusually large" (Keller, 2009, p. 657). As such, it is important to examine these data points since they lie outside the main portion of the data set, and may represent a problem with validity in statistical testing and ultimately the results from a regression model (Keller, 2009; Stevens, 1984). As discussed later in this chapter, for this study all responses were examined to detect if any of them were outliers using the Mahalanobis Distance, a test that is considered to be an appropriate means of detecting outliers (Penny, 1996). This statistical test uses calculations of distance from the mean for a given set of predictors (Stevens, 1984). Results of this test are discussed in the regression model section of this chapter.

[40]The final sample of 210 responses is an appropriate sample size, as the original sample size calculated as necessary using regression analysis was 97 responses to achieve a 95% confidence level. Criteria to calculate the appropriate sample size were from Israel (2014).

Table 4

Descriptive statistics for dependent and independent variables

	Sample[a]
Compensation (COMP)	
Mean	$20,974
(Standard Deviation)	($8,857)
Client Advocacy (ADV)	
Mean	43.67
(Standard Deviation)	(7.75)
Years of Tax Experience (EXP)	
Mean	26.23 years
(Standard Deviation)	(12.23)
Firm Type (FIRM)	
Local	78%
Regional	16%
National/Big 4	6%
Title in Firm (TITLE)	
Principal/Partner	60%
Manager	16%
Director	7%
Senior	6%
Senior Staff	6%
Staff	6%
Gender (GENDER)	
Male	65%
Female	35%
Education (EDUC)	
Bachelor's degree	68%
Master's degree	29%
Doctorate degree	3%
Professional status (CPA)	
CPA	92%
Non-CPA	8%

a = Percentages are based on total number of respondents who provided information for each of these categories

presented in Table 4, while Table 5 summarizes descriptive statistics for the demographic variables for each of the client risk experimental conditions (high and low). Demographics collected were number of years of tax experience, type of firm, the title within the firm, gender, education level achieved, and professional status. The average number of years of tax experience was 26.23 years. Responses indicate that the majority of the participants were male (65 percent), CPAs (92 percent), worked at a local firm (78 percent), held a bachelor's degree (68 percent), and held a principal/partner title (60 percent).

Table 5

Demographic information for client risk

	Experimental Condition High Risk[a]	Experimental Condition Low Risk[a]
Experience		
Mean	25.66 years	26.51 years
(Standard Deviation)	(11.82)	(12.46)
Firm Type		
Local	75%	80%
Regional	18%	15%
National/Big 4	7%	5%
Title in Firm		
Principal/Partner	59%	60%
Manager	11%	19%
Director	10%	5%
Senior	4%	6%
Senior Staff	6%	6%
Staff	10%	4%
Gender		
Male	63%	66%
Female	37%	34%
Education		
Bachelor's degree	62%	71%
Master's degree	32%	27%
Doctorate degree	6%	2%
Professional status		
CPA	93%	91%
Non-CPA	7%	9%

a = Percentages are based on total number of respondents who provided information for each of these categories.

Regression Model Results and Discussion

Overview of regression model

The regression model used in this study had a dependent variable, which was the recommended dollar amount of compensation of an S corporation officer-shareholder, and two independent variables and six demographic independent variables. These variables were client advocacy (ADV), client risk (RISK), years of experience of the tax professional (EXP), firm type (FIRM), the tax professional's title in a firm (TITLE), gender (GENDER), level of education of the tax professional (EDUC), and license of the tax professional (CPA).

This study had two research hypotheses for the independent variables, client advocacy (H_A) and client risk (H_B). H_A related to client advocacy and the compensation recommendation, such that the hypothesized relationship was that for higher (lower) levels of client advocacy, the compensation recommendation would be more (less) aggressive. For H_B, the hypothesized relationship was between client risk and the recommended compensation, such that for lower (higher) perceived levels of client risk, the compensation recommendation would be more (less) aggressive. The regression model is discussed in detail in the next section.

Regression equation

Equation 3.1 presents the regression model used for purposes of this study. Discussion of results of the model are after the presentation of equation 3.1.

Regression analysis data requirements

To ensure valid results from data in a regression model, there are certain factors that must be evaluated, which include tests for multicollinearity, outliers, and tests for regression assumptions (Keller, 2009). Assumptions of regression analysis include normality and homoscedasticity (Keller). In this section, each of these factors and assumptions will be discussed in detail as they relate to the data for this study.

Multicollinearity

Regression analysis involves a dependent variable and one or more independent variables. Regression models are used to analyze how one variable (the dependent variable) might be related to another, independent variable(s) (Hair et al., 2010). As a result, it is possible for some of the independent variables to be correlated with one

another. If independent variables are correlated, it is known as multicollinearity, suggesting that the independent variables are measuring the same construct instead of different constructs. The adverse effect of multicollinearity is distorted regression results (see Hair et al., 2010; O'Brien, 2007).

$$COMP = \beta_0 - \beta_1(ADV) + \beta_2(RISK) + \beta_3(EXP) + \beta_4(FIRM) + \beta_5(TITLE) + \beta_6(GENDER) + \beta_7(EDUC) + \beta_8(CPA) \quad (3.1)$$

Where:

COMP= represents the dependent variable, the recommended dollar amount of compensation of the shareholder of an S corporation

ADV = the independent variable, client advocacy

RISK = the independent variable, client risk

EXP = number of years of experience for the tax professional, a demographic variable

FIRM = firm type, a demographic variable

TITLE = tax professional's title in firm, a demographic variable

GENDER = male or female, a demographic variable, which will be coded as the value of one if male, and zero if female

EDUC = level of education of tax professional, a demographic variable

CPA = the license a tax professional holds, a demographic variable

One way to test for multicollinearity is to examine variance inflation factors (VIF). VIF tests whether there is a strong linear relationship between an independent variable and all other independent variables found in a model (Mertler & Vannatta,

2002).[41] The VIF for each independent variable in this study was calculated and presented in Table 6. For regression analysis, a common threshold used is that if a calculated VIF is greater than 5, multicollinearity problems may exist (Menard, 1995).[42] VIFs for the independent variables in this study are less than 5, except for one variable,

Table 6

Variance inflaction factors for independent variables

Regression Term	Variance Inflation Factor (VIF)
Client Advocacy (ADV)	1.14
Client Risk (RISK)	
High	
Low	1.06
Years of Experience (EXP)	1.54
Firm Type (FIRM)	
Local	
National/Big 4	1.51
Regional	1.25
Title (TITLE)	
Director	
Manager	3.78
Principal/Partner	6.08
Senior	2.29
Senior Staff	2.26
Staff	2.69
Gender (GENDER)	
Female	
Male	1.17
Education Level (EDUC)	
Bachelor's degree	
Doctorate degree	1.15
Master's degree	1.13
Professional License (CPA)	
No	
Yes	1.45

[41] The variance inflation factor (VIF) is a measure of multicollinearity, and is "calculated as the inverse of the tolerance value" (Hair et al., 2010, p. 201). Furthermore, the tolerance value is defined as the "amount of variability of the selected independent variable not explained by the other independent variables" (Hair et al., 2010, p. 201), and a tolerance value has a range from 0 to 1 (Mertler & Vannatta, 2002). Thus, higher amounts of multicollinearity are indicated by lower tolerance values and higher VIF values (Hair et al., 2010).

[42] Menard (1995, p. 66) states that "a tolerance that is less than .20 is cause for concern." A tolerance level of .20 is equal to a VIF factor of 5, since a VIF value is the inverse of a tolerance value. Thus, this gives a basis for considering VIF values that are greater than five.

suggesting that these independent variables may not have not serious multicollinearity issues. Since R^2 is relatively low in this model (see Table 8), the variable with a VIF of more than five was not removed from the analysis.[43]

Another statistical procedure to test for relationships between variables is the coefficient of correlation, or Pearson's *r*, which helps to describe the linear relationship between two variables (Keller, 2009). The coefficient of correlation shows correlation between a dependent and independent variable, and it will also show if there is multicollinearity between two independent variables. Figure 2 displays the correlation scatterplot for the continuous variables in this study. The scatterplots give a visual representation of the relationship between variables (Keller, 2009).

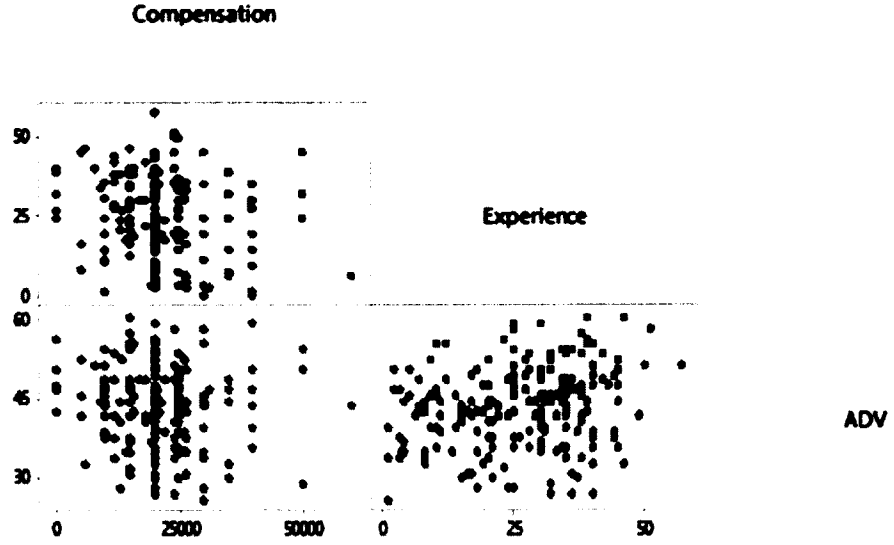

Figure 2. Scatterplot of continuous variables for correlation

Moreover, the coefficient of correlation (Pearson's *r*) provides a numerical depiction of the relationship between variables (see Table 7). The correlation coefficient

[43] According to O'Brien (2007), it is important to examine all aspects of a model before removing variables from a model simply based on certain VIF thresholds. The R^2 in this model is low, so it is not necessary to remove a variable simply because the actual VIF calculation is slightly larger than a typical threshold value.

calculated between compensation (COMP) and years of experience (EXP) is -0.180 and has a p-value of 0.009. This correlation is statistically significant ($p < 0.05$), and the relationship is an inverse relationship. This inverse relationship indicates that as years of experience increase, the amount of recommended compensation decreases. The correlation coefficient calculated for compensation (COMP) and client advocacy (ADV) was -0.101 and has a p-value of 0.143. This correlation indicates an inverse relationship, but is not statistically significant ($p < 0.05$). Lastly, the correlation coefficient for years of experience (EXP) and client advocacy (ADV) is 0.213 and the p-value is 0.002 for this correlation. This correlation coefficient is statistically significant ($p< 0.05$). Since the correlation for years of experience (EXP) and client advocacy (ADV) is closer to zero, it indicates that there is not a linear relationship between years of experience (EXP) and client advocacy (ADV).

Table 7

Correlations for Compensation (COMP), years of experience (EXP), and client advocacy (ADV)

	Compensation (COMP)	Experience (EXP)
Experience (EXP)	-0.180 0.009	
Client Advocacy (ADV)	-0.101 0.143	0.213 0.002

Note: Cell contents — Pearson correlation
P-value

Outliers

Outliers are data points that are "unusually large or small observations" (Keller, 2009, p. 119). Validity of the observation becomes doubtful with observations that are outside of the main data set. Data sets should be examined for outliers since including

outliers in a data set may cause the results from the data to be distorted (Hair, Black, Babin, & Anderson, 2010).

When a model has more than two independent variables, it is said to be multivariate. Procedures to detect outliers must be appropriate for multivariate models. One such procedure to detect outliers in multivariate analysis is called the Mahalanobis Distance test. This method measures each data point's distance from the mean, which makes an assessment for all observations, and provides a "single value for each observation no matter how many variables are considered" (Hair et al., 2010, p. 66). This test uses a chi-squared statistic to evaluate the Mahalanobis Distance value for each observation. Figure 3 illustrates the observations in this study that were considered outliers (these were observations above the chi-square value).[44] For this study, it was concluded that the outliers identified in Figure 3 were extraordinary outliers, or outliers for which there is not a valid explanation (Hair et al.). These outliers were considered to not have a valid explanation since the values given for the dependent variable (COMP) were unusually large given the facts of the tax case scenario [see Appendix B for the tax case scenario and manipulation of client facts for client risk (RISK) used in the survey instrument]. Therefore, these outlier observations were not retained in the final analysis.

[44] The Mahalanobis Distance procedure uses a chi-square statistic to evaluate possible outliers; the degrees of freedom in this test equals the number of independent variables in the model, and the level of significance used is $p < .001$ (Mertler & Vannatta, 2002). Outliers are determined by comparing the Mahalanobis Distance value for each independent variable against the chi-square statistic (also known as the chi-squared critical value) (Mertler & Vannatta). If an independent variable has a Mahalanobis Distance that is greater than the chi-square statistic, it is considered an outlier (Mertler & Vannatta). Figure 2 represents the Mahalanobis Distnace test generated by Minitab for the continuous variables in this study. The points that are above the chi-square statistic (which is 2.818 in Figure 2) are considered outliers. A brush function in Minitab was used to select these specific data points above this line and remove them from the final analysis.

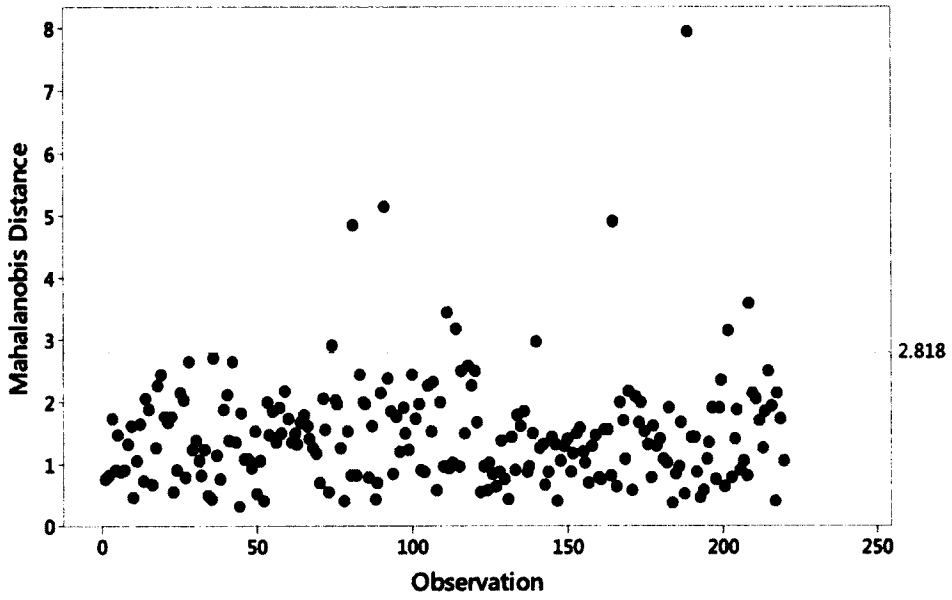

Figure 3. Outlier plot of compensation (COMP), years of tax experience (EXP), and client advocacy (ADV).

Assumptions of regression analysis

Certain assumptions that need to be examined in regression analysis are normality and homoscedasticity. These assumptions are discussed as they relate to the data for this study.

Normality describes the "shape of the data distribution for an individual metric variable and its correspondence to the normal distribution" (Hair et al., 2010, p. 71). If non-normality exists within the data set, it can be problematic since normality is a requirement of data for certain statistical testing to be valid (Hair et al.). Normality can be tested by graphical representations of the data. Two graphical approaches to examine normality are a histogram and a normal probability plot. To assess normality using a histogram, a visual check is used to examine whether data points approximate a normal distribution. Figure 4 presents a histogram of the data for this study, which visually indicates normality for the data used in this study. Likewise, the normal probability plot

suggests normality for this study's data since the line that represents the data follows somewhat closely the line that represents a normal distribution (see Hair et al., 2010).

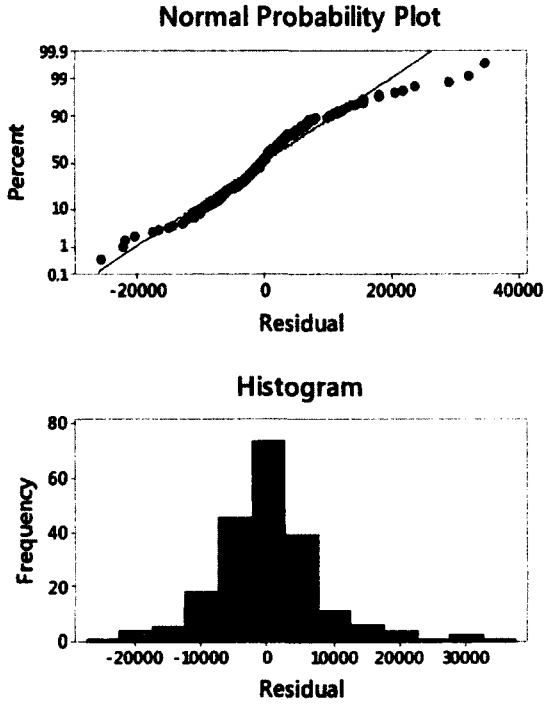

Figure 4. Residual plots for compensation (COMP).

Homoscedasticity is the assumption that describes variability between observations, and describes when the variability between observations for one variable is usually the same for all observations of another variable. It is important that homoscedasticity is present within the data since the explanation of variance for the dependent variable should not be concentrated in a limited range of the independent variables. If there is unequal variance spread across the independent variables, it is said that the relationship between the dependent and independent variables are heteroscedastic.

Graphical representations illustrate one method for testing the data for homoscedasticity. The "versus fit" and the "versus order" diagrams can test for

homoscedasticity, and Figure 5 shows these diagrams for the data in this study. To test

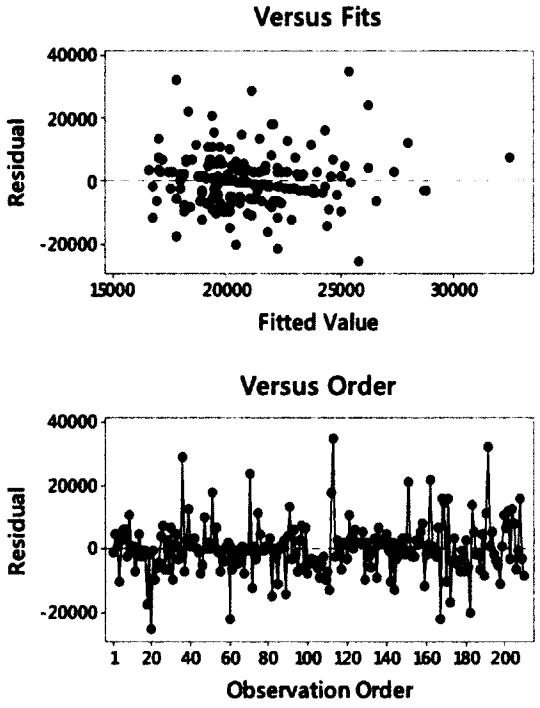

Figure 5. Residual plots for compensation (COMP).

for homoscedasticity, these diagrams are examined for unequal dispersions and patterns among observations. For the "versus fit" diagram, there appears to be an equal dispersion of all observations across the residuals, suggesting homoscedasticity within this study's data set. In the "versus order" diagram, there does not appear to be any pattern within the observed data points, which also suggests homoscedasticity for this study's data set.

Discussion of regression model results

The purpose of this study is to examine the relationship between client advocacy, client risk, and a tax professional's recommendation of compensation for an officer-shareholder of an S corporation. Multiple regression analysis was used to study this relationship, and statistical software (Minitab) was used to perform analyses for this

study. Multiple regression analysis is used since it is a statistical technique that allows for one, continuous dependent variable, and multiple independent variables that may be continuous or categorical.

The results of the regression model used in this study are presented in Table 8. P-values that were calculated are given for each of the independent variables within the model, and these values were used to predict whether the variable was statistically significant at the 95% confidence level. In multiple regression analysis, if independent variables are statistically significant, it is suggested that the independent variable has a relationship with the dependent variable.

According to the regression analysis results, the model had an R^2 of 7.90%. The R^2 is also known as the coefficient of determination[45], and it helps to explain the variation in the model from the independent variables (Keller, 2009). Thus, 7.90% of the variation in the recommended compensation amount in this study was explained by the independent variables included in the model.

[45] Specifically, the coefficient of determination, or R^2, "measures the amount of variation in the dependent variable that is explained by the variation in the independent variable" (Keller, 2009, p. 135).

Table 8

Regression Analysis Results

Regression Term	Coefficients	F-value	P-value
Client Advocacy (ADV)	-93.2	1.23	0.268
Client Risk (RISK)		0.15	0.696
High	0.0		
Low	-518		
Years of Experience (EXP)	-97.5	2.50	0.115
Firm Type (FIRM)		0.05	0.955
Local	0.0		
National/Big 4	978		0.761
Regional	92		0.960
Title (TITLE)		0.51	0.771
Director	0.0		
Manager	492		0.878
Principal/Partner	1839		0.548
Senior	4970		0.211
Senior Staff	1444		0.714
Staff	661		0.878
Gender (GENDER)		0.71	0.401
Female	0.0		
Male	-1163		
Education Level (EDUC)		2.46	0.088
Bachelor's degree	0.0		
Doctorate degree	7220		0.048
Master's degree	-842		0.557
Professional License (CPA)		1.40	0.238
No	0.0		
Yes	-3177		

Regression Model Summary

S = 8799.75 R-sq = 7.90% R-sq (adj) = 1.29%

Analysis of Variance output

Source	DF	SS	MS	F	P
Regression	14	1295310216	92522158	1.19	0.282
Error	195	1.51E+10	77435640		
Total	209	1.6395E+10			

For the regression model, the dependent variable was the recommended dollar amount of compensation for an S corporation, and the dependent variable was continuous. Independent variables were client advocacy (ADV) and client risk (RISK). Other independent variables in the study were years of experience of the tax professional (EXP), firm type (FIRM), the tax professional's title in a firm (TITLE), gender (GENDER), level of education of the tax professional (EDUC), and license of the tax professional (CPA). Explanations of these variables are presented below.

Client advocacy (ADV) was a continuous variable, and measured by a 9-point advocacy scale first developed by Mason and Levy (2001). Client advocacy (ADV) had

a p-value of 0.268 in this study's model (see Table 8). At a confidence level of 95%, the p-value for client advocacy (ADV) suggests that client advocacy does not relate to the dependent variable, compensation. Participants were asked to rank each statement in the advocacy scale using a seven-point Likert-type scale, ranging from 1 (strongly disagree) to 7 (strongly agree), and client advocacy (ADV) was measured by summing the scores from participants from each of the nine advocacy scale statements. Means and standard deviations for each of the items on the advocacy scale are presented in Table 9.

For this study, the means and standard deviations of responses for each statement are presented in Table 9. The overall mean and standard deviation of the 9 items was 43.67 (7.75).[46] These statistics indicate that the answers from participants in this research were similar to past studies that have used this advocacy scale. This is important since this study used this scale to measure more specifically client-specific advocacy, rather than general advocacy. In addition, these data are consistent with a past study that also measured client-specific advocacy (see Bobek et al., 2010).

[46] The overall mean of the responses to the advocacy scale from participants in this study suggests similarity in responses from past research studies. For this study, the overall mean to the 9-point advocacy scale was 43.67. The average score reported by past studies are 46.03 (study performed by Davis & Mason, 2003), 42.43 (study conducted by Bobek et al., 2010), and 43.88 (study performed by Kahle & White, 2004). This study, as well as the study performed by Bobek et al. (2010), measured client-specific advocacy, while the studies performed by Davis and Mason (2003) and Kahle and White (2004) measured general advocacy.

Table 9

Mason and Levy (2001) Advocacy Scale Means and Standard Deviations

	Client-Specific Advocacy: Mean (SD)
Question 1: In an instance where no judicial authority exists with respect to an issue and where the Code and Regulations are ambiguous, I feel that the taxpayer is entitled to take the most favorable tax treatement.	5.11 (1.35)
Question 2: Generally speaking, my loyalties are first to the tax system, then to the taxpayer. (Item is reverse-coded.)	4.31 (1.74)
Question 3: I feel I should apply ambiguous tax law to the taxpayer's benefit.	4.65 (1.57)
Question 4: When examining a tax return, I tend to point out to taxpayers reasonable positions they could have taken which would have contributed to minimizing their tax liability.	5.99 (1.06)
Question 5: I believe it is important that I encourage the taxpayer to pay the least amount of taxes possible.	4.43 (1.69)
Question 6: I always interpret unclear/ambiguous laws in favor of the taxpayers.	4.32 (1.37)
Question 7: It is important to use trends in the law by trying to establish a pattern of more favorable treatment for the taxpayer and then extending this pattern to the taxpayer's position.	4.90 (1.20)
Question 8: Where no authority exists with respect to an issue, I feel that the taxpayer is entitled to take the most favorable tax treatment.	5.16 (1.22)
Question 9: The taxpayer has the right to structure transactions in ways that yield the best tax result, even if the law is unclear in an area.	4.79 (1.45)
Overall	43.67 (7.75)

Data for this scale are based on responses for each applicable item from all participants that gave responses.

All items in this scale were rated using a seven-point scale, ranging from strongly disagree to strongly agree. Scores from each item in the scale were summed for an aggregate score, with a possible minimum total score of 9 and a possible maximum total score of 63.

Client risk (RISK) was a manipulated variable between subjects, with a high and low experimental condition. Manipulation of client risk (RISK) was accomplished through different descriptions of the hypothetical taxpayer in the tax case scenario used in the survey instrument. The hypothetical taxpayer in the high-risk manipulation was described as having weak financial records and uncooperative, suggesting tax saving strategies often, and had previous Internal Revenue Service (IRS) audits. The hypothetical taxpayer in the low risk manipulation was described as having strong financial records, avoiding tax savings strategies, and had never had an IRS audit. Client risk (RISK) was operationalized using these different descriptions for the hypothetical

taxpayer, consistent with prior research (see Appendix B for the descriptions of the high risk taxpayer and the low risk taxpayer used in the survey instrument). The independent variable, client risk (RISK), had a p-value of 0.696 in this model (see Table 8). This indicates that client risk (RISK) does not relate to the dependent variable, compensation.

This study examined other independent variables, in addition to client advocacy (ADV) and client risk (RISK), due to the influence these variables have on tax professional recommendations, as found in prior research. Years of experience of the tax professional (EXP) was a continuous variable, as participants were asked to give the number of years of tax experience they have. Years of experience for the tax professional (EXP) had a p-value of 0.115, indicating that years of experience was not statistically significant within this study's model (see Table 8).

Firm type (FIRM) was a discrete variable, with three different classifications, ranging from a local firm to a national/Big 4 firm.[47] Each of the three categories represented by the firm type variable (FIRM) were coded as 1, 0 in the regression model. This created two binary (dummy) variables within this study's model (see Table 8). Firm type (FIRM) was not statistically significant in this model and had a p-value of 0.955 (see Table 8).

A tax professional's title within a CPA firm (TITLE) was also an independent variable in this study's model. The title held by a participant was an ordinal variable, and participants were able to choose from six different titles that are commonly found in accounting firms. The six different titles used in this study were Staff, Senior Staff,

[47] Firm type (FIRM) was originally a discrete variable with four different classifications (local firm, regional firm, national/Big 4 firm, and international firm). In the final analysis, the international firm category was removed from the study since there was only one respondent in this category.

Senior, Manager, Director, and Principal/Partner. Each classification for the title variable (TITLE) was coded as 1, 0. Having six different classifications for the tax professional title variable (TITLE) created five binary (dummy)[48] variables for this study (see Table 8). Title of the tax professional (TITLE) had a p-value of 0.771 in this research model, indicating that it was not statistically significant (see Table 8).

Gender (GENDER) was also an independent, binary variable in this study's model, and the variable was limited to two classifications (male and female). Gender (GENDER) had a p-value of 0.401, which indicated that this variable was not statistically significant in this research model (see Table 8).

Education level of the tax professional (EDUC) was also obtained as an independent variable in this study. Education level (EDUC) was captured by having the participant acknowledge the type of degree earned. Education level (EDUC) was ordinal, and had three classifications,[49] which created two binary variables within the model see (Table 8). Each category of the education variable (EDUC) was coded as 1, 0 in the regression model.

The independent variable, education level (EDUC), had a p-value of 0.088 within this study's regression model (see Table 8). The p-value suggests that this independent variable was not statistically significant. However, in the regression analysis, the doctorate degree category, when compared to the bachelor's degree category, has a p-value of 0.048 (see Table 8), which suggests that the difference between compensation

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[48]A dummy variable is a "special metric variable used to represent a single category of a nonmetric variable" (Hair et al., 2010, p. 35). Thus, a nonmetric variable that has *k* classifications will have *k*-1 dummy variables which accounts for each level of the variable (Hair et al.).

[49] Education level of the tax professional (EDUC) was originally going to be measured using five classifications: No degree, high school degree, bachelor's degree, master's degree, and doctorate degree. In the final analysis, the categories, No degree and High school degree, were removed since these classifications had no responses or only one response.

amounts recommended for those who hold a doctorate degree and those who hold a bachelor's degree are statistically significant ($p < 0.05$). These results are described in the next section.

Lastly, professional status of the tax professional (CPA) was an independent variable in this study's model. Professional status (CPA) was a binary variable, and participants were able to choose between two classifications, CPA or non-CPA. Professional status (CPA) was a variable with two categories in the regression model; this variable was coded as 1, 0. Professional license (CPA) had a p-value of 0.238, suggesting that this variable is not statistically significant (see Table 8).

Research Questions and Hypotheses

Hypothesis H_A

There were two research hypotheses examined in this study. The first research hypothesis relates to tax professional recommendations and client advocacy levels. The first hypothesis, stated in the null form, is presented below.

H_{0A}: There is no statistical difference between recommendations for compensation of officer-shareholders from tax professionals that exhibit low or high client advocacy levels towards S corporation clients.

The result of this hypothesis was predicted using the following hypothesis:

H_{1A}: Tax professionals will make more (less) aggressive recommendations for officer-shareholder compensation when exhibiting high (low) advocacy levels towards S corporation clients.

Results of hypothesis H_A

This hypothesis addresses the relationships that this study seeks to investigate between S corporation compensation and client advocacy. Regression analysis was used to analyze the results from the study's survey. Results for this hypothesis are discussed below.

The independent variable, client advocacy (ADV), was a measured variable, using a nine-point scale first developed by Mason and Levy (2001) (see Appendix A for the advocacy scale statements). In this research, the Mason & Levy (2001) advocacy scale was used to measure a tax professional's mind-set specific to a hypothetical client, resulting in a measurement of client-specific advocacy, similar to the study performed by Bobek et al. (2010). Participants ranked each statement on the advocacy scale using a seven-point Likert-type scale, ranging from 1 (strongly disagree) to 7 (strongly agree). Scores from each statement were then summed for an aggregate total, with a possible minimum score of 9 and a possible maximum score of 63. Eight out of the nine statements emphasized advocacy as it relates to a taxpayer, and one of the questions (specifically Question 2 in the scale) emphasized a tax professional's loyalty to the tax system. As a result, participants' answers from Question 2 from the advocacy scale were reverse coded in the statistical analysis. The higher the summed scores from the nine statements were indicative that the tax professional conveyed an attitude towards the attributes of advocacy as they related to the hypothetical client (see Mason & Levy, 2001). A listing of the counts, percentages, means, and standard deviations for each of the items in the advocacy scale for this study can be found in Table F1.

Hypothesis H_A addressed the relationship between client advocacy (ADV) and a tax professional's compensation recommendation (COMP). Compensation (COMP) was a numeric value given by each participant. The negative sign of the client advocacy variable (ADV) in this study's model is consistent with the hypothesized sign. However, the regression model did not show statistical significance for the relationship of the recommended compensation variable (COMP) and the client advocacy variable (ADV). In the analysis for the regression model, the p-value associated with client advocacy (ADV) as a predictor of compensation was 0.268 (see Table 8). Therefore, the hypothesized relationship between client advocacy (ADV) and a tax professional's compensation recommendation (COMP) was not statistically significant ($p < 0.05$).

Hypothesis H_B

The second research hypothesis relates to tax professional recommendations and client risk levels. The second hypothesis, stated in the null form, is presented below.

H_{0B}: There is no statistical difference between recommendations for officer-shareholder compensation for S corporation clients that are considered low risk or high risk by tax professionals.

The result of this hypothesis was predicted using the following hypothesis:

H_{1B}: Tax professionals will make more (less) aggressive recommendations for officer-shareholder compensation for S corporation clients considered low (high) risk.

Results of hypothesis H_B

This hypothesis addresses the relationship that this study seeks to investigate between S corporation compensation and client risk. Regression analysis was used to

analyze the results from the study's survey. Results for this hypothesis are discussed below.

For this study, the independent variable, client risk (RISK), was a manipulated variable across experimental conditions. Client risk (RISK) was either high or low based on client characteristics and descriptions adapted from past research (see Bobek et al., 2010; Kadous & Magro, 2001). To ensure that the client risk manipulation was effective, participants were asked to evaluate the degree of client risk that was created to maintain the hypothetical tax client in relation to clients at their respective firms.[50] Participants used a scale of 1 (no risk) to 7 (very high risk) to rate the level of risk for the hypothetical client. The mean and standard deviation for the high-risk client experiment group was 4.86 (1.29), and the mean and standard deviation for the low risk client experiment group was 3.57 (1.20) (see Table F2). To assess whether the manipulation for client risk between the high and low experimental groups was effective, an analysis of variance (ANOVA) was performed. The p-value found in the ANOVA for these two groups (high risk and low risk experimental conditions) was 0.00. The ANOVA computation indicates that these two experimental groups are different at $p < 0.05$. This result suggests that the client risk manipulation was effective. Listings of the counts, percentages, means, and standard for the high risk condition and the low risk condition can be found in Table F2.

Hypothesis H_B addressed the relationship between client risk (RISK) and a tax professional's compensation recommendation (COMP). The results of the regression analysis performed for Hypothesis H_B indicate that there is not a relationship between a

[50] This procedure has been used by past studies to test the effectiveness of the manipulation of client risk (see Bobek et al., 2010, and Kadous and Magro, 2001).

tax professionals' compensation recommendation (COMP) and the type of client [high risk client or low risk client] (RISK).

The independent variable, client risk (RISK), was a manipulated variable with two categories (high and low) across experimental designs. Compensation (COMP) was a numeric value given by participants. The positive sign of the client risk variable (RISK) in this study's model is consistent with the hypothesized sign. However, the results of the regression model did not indicate statistical significance for relationship between these two variables. In the regression analysis, the p-value associated with client risk (RISK) as a predictor of compensation (COMP) was 0.696 (see Table 8). Therefore, the hypothesized relationship between client risk and a tax professional's compensation recommendation was not statistically significant ($p < 0.05$).

In addition to testing the relationship stated in hypothesis H_B, an ANOVA was utilized to test whether there was a difference between the compensation amounts recommended by participants (COMP) in the high and low risk experimental conditions (RISK). The ANOVA revealed a p-value of 0.568 between the two experimental conditions (see Table 10). Thus, the difference between the compensation recommendations in the high risk condition and the low risk condition were not statistically significant ($p < 0.05$).

Table 10

Analysis of Variance (ANOVA) Results

Categorical Variable	P-value
Client Risk (RISK)	0.568
High	
Low	
Firm Type (FIRM)	0.889
Local	
National/Big 4	
Regional	
Title (TITLE)	0.761
Director	
Manager	
Principal/Partner	
Senior	
Senior Staff	
Staff	
Gender (GENDER)	0.445
Female	
Male	
Education Level (EDUC)	0.571
Bachelor's degree	
Doctorate degree	
Master's degree	
Professional License (CPA)	0.223
No	
Yes	

Demographic variables results

The demographics that were collected in this study were years of tax experience (EXP), firm type (FIRM), the title within the firm (TITLE), gender (GENDER), education level (EDUC), and professional status (CPA). These demographics were important to this study, as they have been studied in past studies involving ambiguous tax scenarios, tax preparer aggressiveness, and client advocacy (see Ayres et al., 1989; Bobek et al., 2010; Carnes et al., 1996; Kadous & Magro, 2001; Kadous et al., 2008; Kelliher et

al., 2001; McGill, 1988; Roberts, 1998). A one-way analysis of variance (ANOVA)[51] was used to test each of the categorical and ordinal variables and measure if there was a difference between the classifications represented by each variable. Categorical variables were firm type (FIRM), gender (GENDER), and professional license (CPA); ordinal variables were title (TITLE) and education level (EDUC). Results for the ANOVA performed on each demographic, categorical, and ordinal variables are presented in Table 10.

The variable tax experience (EXP) was a continuous variable, and participants were asked to provide a number in years that represented how much tax experience they had. Past research has indicated that years of tax experience can influence a tax professional's reporting recommendations, but results are generally mixed. Past research results are mixed regarding the variable experience, but some studies have found a link between tax experience and aggressive reporting recommended by tax professionals (Helleloid, 1989; McGill, 1988).

This study investigated tax experience (EXP), which is an important variable when making recommendations in ambiguous tax settings since tax professionals rely on an accumulation of knowledge to make such decisions (Kaplan et al., 1988). It was expected that participants with more experience would recommend lower compensation amounts. Based on statistical analysis, years of tax experience (EXP) was not found to be statistically significant as a predictor of compensation. In this study's regression model, tax experience had a p-value of 0.115 (see Table 8). Therefore, years of tax

[51] Analysis of variance (ANOVA) is a statistical test that determines whether "samples from two or more groups come from populations with equal means" (Hair et al., 2010, p. 440). More specifically, a one-way ANOVA test was used since it involves comparing the means of the dependent variable and any number of conditions that are grouped over a single element (independent variable) (Rutherford, 2011).

experience (EXP) was not statistically significant and did not illustrate a relationship between the number of years of tax experience of a tax professional and the compensation amount recommended (COMP) ($p < 0.05$).

Firm type (FIRM) was a discrete variable and was captured in three different categories (local, regional, and national/Big 4).[52] This demographic variable was investigated in this study due to results of past research that studied firm type as a preparer characteristic; these studies found that there was a difference in reporting recommendations among CPAs (Carnes et al., 1996; Roberts, 1998) and differences in attitudes among CPAs at different-sized firms (Cuccia, 1995). Recommendations from tax professionals were found to be different across different firm types (Helleloid, 1989), and one study found that professionals at national firms may be more aggressive than professionals at local or regional firms (Stephenson, 2007). In this study, it was expected that firm type (FIRM) would impact the dependent variable, compensation, such that tax professionals from national firms will recommend more aggressive compensation amounts than professionals at local or regional firms.

Since firm type (FIRM) was a discrete variable with three different categories, an ANOVA was used to determine if there was a difference in the amount of compensation recommended (COMP) among the firm type categories (FIRM). In the ANOVA, the p-value was 0.889 (see Table 10). Therefore, the ANOVA indicates that, for the categories of firm type (FIRM), none are statistically significant ($p < 0.05$).

[52] A local firm was defined as a firm with less than 50 employees and one office. A regional firm was defined as a firm with 50 or more employees and 5 or more office locations. Lastly, a national firm was defined as a "Big 4" firm.

Title of the tax professional (TITLE) was a demographic variable that was examined in this study since the position a tax professional holds may influence a recommendation. Public accounting firms are staffed with experienced tax professionals (such as supervisors, managers, and partners) and less-experienced staff (staff accountants). Prior research regarding title within a firm has studied various constructs as it relates to experienced versus less-experienced accountants. Barrick et al. (2004) found that supervisors may be more likely to meet the advocacy objective for recommendations when the accuracy objective is not met. The variable title (TITLE) was ordinal, and participants were able to select from among six different titles that are common in accounting firms and have been used in past research (see Bobek et al.,2010; Chow et al., 1989; Karlinsky & Koch, 1987).[53]

It was expected that higher-level accountants in this study would be more likely to recommend a lower compensation amount than less-experienced staff accountants, which is consistent with a client-favored (advocacy) position. An ANOVA was performed to test if there was a difference in compensation amounts recommended among positions. In the ANOVA for title, the p-value was 0.761 (see Table 10). As a result, the ANOVA indicates that the expected relationship between title (TITLE) and the compensation amount recommended (COMP) is not statistically significant ($p < 0.05$).

This study also examined gender (GENDER) since prior research has shown that there are differences in gender and risk aversion (see Kelliher et al., 2001; Roberts, 1998; Sanders & Wyndelts, 1989). Females have been found to be more risk-averse than males in past research (Byrnes et al., 1999). Tax research has also indicated differences in

[53] The categories for title variable were Director, Manager, Principal/Partner, Senior, Senior Staff, and Staff.

recommendations between males and females. It is more likely for a male to recommend a client-favorable tax position and make more aggressive recommendations than females (see Bobek et al., 2010; McGill, 1988; Sanders & Wyndelts, 1989). Gender (GENDER) was a binary variable (limited to two categories, male or female).

It was expected for this study that male tax professionals would recommend lower compensation amounts, which would indicate a more aggressive and client-favored recommendation. An ANOVA was performed to test if there was a difference between the recommendations (COMP) made by male and female tax professionals (GENDER). The p-value found for this ANOVA was 0.445 (see Table 10). Therefore, the expected difference in the compensation amount recommended between male and female tax professionals in this study was not statistically significant ($p < 0.05$).

The demographic variable, education level (EDUC), was investigated in this study since differences in reporting decisions from tax professionals have been associated with education in past research (Bonner et al., 1992; Karlinsky & Koch, 1987). Formal taxation training was linked to greater tax transaction knowledge (Bonner et al., 1992) and having more formal education has been linked to more aggressive recommendations by tax professionals (Carnes et al., 1996). Education was an ordinal variable, with three classifications,[54] and was measured in type of degree earned by the participant, which is consistent with past studies (see Carnes et al., 1996; Karlinsky & Koch, 1987). The results of the regression model indicated that the category, doctorate degree, for the

[54] The three education (degree type) categories were Bachelor's degree, Master's degree, and doctorate degree. The survey instrument listed five categories, but the final analysis did not include the categories, "No degree" and "High school degree", since they had no responses and one response, respectively.

education variable (EDUC) was statistically significant ($p < 0.05$). This suggests that this category was a significant predictor of compensation (COMP) (see Table 8).

It was expected that the more formal education a participant had, the lower the compensation recommendation would be. A one-way ANOVA was performed to test if there was a difference in the compensation amount recommended (COMP) among the different types of degrees earned by study participants (EDUC). The ANOVA revealed a p-value of 0.571 (see Table 10). Thus, the expected difference in the recommended compensation amounts among the degree type of a study participant was not statistically significant ($p < 0.05$). Summarily, the regression model suggests that the doctorate degree category for the education variable (EDUC) was a predictor of the compensation recommended (COMP), but the ANOVA suggested that there was no difference in the mean compensation (COMP) recommended across the education variable categories (EDUC).

Licensure/professional status (CPA) was a demographic variable that was investigated in this study due to the link between professional status and tax preparer decision making in past research. Studies suggest that a CPA recommends positions that are more favorable to the taxpayer and advocate more for the taxpayer than non-CPAs (Ayres et al., 1989). Professional status (CPA) was captured using two different categories, making this a binary variable.[55]

It was expected that a CPA would recommend a lower compensation amount than a non-CPA. An ANOVA was performed to test whether there is a difference between the amounts of compensation recommended (COMP) by CPAs versus non-CPAs (CPA).

[55] Participants chose between the options that they were a CPA or not a CPA.

The p-value found for this analysis was 0.223 (see Table 10). Therefore, the ANOVA indicates that the expected difference between the amount of compensation that was recommended from a CPA and a non-CPA is not statistically significant ($p < 0.05$).

Summary

This study investigated the relationships between client advocacy, client risk, and the tax professional's compensation recommendation for a shareholder-officer in an S corporation. There was no statistically significant relationship found between client advocacy and the recommendation of compensation from tax professionals (H_A). There was no statistically significant relationship found between the recommendation of compensation from a tax professional and client risk (H_B). Furthermore, there was no difference found between the amount recommended from participants in the high risk experimental condition and participants in the low risk experimental condition (H_B).

Additional analyses showed that there was no statistically significant relationship among the demographic variables that influenced a tax preparer's compensation decision. Likewise, no significant differences were found among the demographic variables of years of tax experience, firm type, title, gender, education level, and professional status/licensure. The implications of these results are discussed in the next chapter.

Chapter 5 – Summary

Taxpayers in the United States (U.S.) are becoming more likely to hire professional tax preparers due to the complexity that is found in the U.S. tax code (Hite & McGill, 1992; Pei et al., 1990). Tax professionals are increasingly faced with making recommendations that involve ambiguous tax transactions as a result of the tax code complexity. Tax professionals have been trained and have specialized expertise and knowledge. Taxpayers are steadily using the expertise and knowledge set that tax professionals possess to help them navigate the tax code and to be compliant with regards to tax preparation, particularly in areas of ambiguity. Therefore, tax professionals find themselves being called upon to make recommendations for various ambiguous tax transactions (DeZoort et al., 2012).

An ambiguous tax issue present in the current United States (U.S.) tax code is determining reasonable compensation for officer-shareholders of S corporations. Compensation is required for officer-shareholders in an S corporation, but there is no absolute amount for what defines reasonable compensation in the Internal Revenue Code (IRC). It represents an ambiguous area in the tax code since determining officer-shareholder compensation is situational, not a formulation of exact law (Fellows & Jewell, 2006). The importance of determining compensation stems from the rather distinct opportunity for officer-shareholders of S corporations to attempt to avoid certain payroll taxes by defining lower compensations amounts as "reasonable."

Having no absolute definition of reasonable compensation often becomes a complex tax issue for tax professionals (Jackson & Milliron, 1989). Therefore, it is important to investigate how tax professionals make recommendations for an ambiguous

tax transaction, such as determination of compensation for officer-shareholders of S corporations.

Professional standards (see AICPA, 2010) indicate that tax professionals act as advocates, within legal boundaries, for their clients. However, these same professional standards also admonish tax professionals that they advocate for the tax system. Tax professionals provide understanding to taxpayers concerning reporting uncertain tax transactions on their tax returns through research; this type of assistance originates from a tax professional's responsibility of client advocacy (Cloyd & Spilker, 1999). Therefore, it is not always possible for a tax professional to advocate for both parties.

When tax professionals make recommendations, they must evaluate all relevant tax authorities and facts about the tax transactions, whether ambiguous or not, in an objective manner. At times, tax professionals are exposed to certain client-based risk factors that may hinder them from unbiasedly evaluating information and satisfying the advocacy role (Kadous & Magro, 2001). Thus, client risk, and its associated factors, become a central part of a tax professional's advocacy role, as the perception of client risk may influence the level of advocacy the tax professional is willing to provide to that client.

This study examined if there was a relationship between client advocacy and client risk and a tax professional's recommendations of compensation for an officer-shareholder of an S corporation. Prior research has suggested a link between client advocacy, client risk, and a tax professional's recommendation regarding an ambiguous tax transaction (see Bobek et al., 2010). Further, past studies have shown a link between client advocacy and aggressive reporting for ambiguous tax positions (see Cuccia et al.,

2005; Schisler, 1994). Previous studies have also investigated client risk and levels of client risk based on certain client characteristics. Moreover, past literature suggests a link between the level of client risk perceived by a tax professional and the type of recommendation a tax professional will make, whether aggressive or non-aggressive (Duncan et al., 1989; Hackenbrack & Nelson, 1996; Kadous & Magro, 2001; Kadous et al., 2008). While past studies have examined ambiguous tax transactions, client advocacy, and client risk, no research was found that consider the relationship between client advocacy, client risk and tax professional's recommendation regarding compensation for an S corporation officer-shareholder. This research investigated this relationship as it relates to an ambiguous tax transaction.

The purpose of this study was to examine a tax professional's recommendation of compensation for an officer-shareholder of an S corporation, and whether this recommendation was related to client advocacy or client risk. Participants for this study came from a state society of CPAs in the United States (U.S.). Client risk was a manipulated variable, as high risk or low risk. The operationalization of client risk was through descriptions of a hypothetical client in a tax case scenario, and at the start of the survey, participants responded to the low risk or high risk experimental condition. Communication with participants was through a pre-scripted email (Appendix E) that was sent out by a senior manager of executive operations/member services from the state society. This study was investigated through the use of a survey that included a hypothetical tax case and various questions relating to the research (see Appendix A for the advocacy scale questions; see also Appendix B for tax cases). Participants were also

asked several demographic questions at the end of the survey (see Appendix C). The final sample consisted of 210 participants from the state society of CPAs.

Findings

This study employed two research hypotheses. These hypotheses and their results are presented below.

Hypothesis H_A

The first research hypothesis relates to tax professional recommendations and client advocacy levels.

H_{1A}: Tax professionals will make more (less) aggressive recommendations for officer-shareholder compensation when exhibiting high (low) advocacy levels towards S corporation clients.

This study did not find any significance ($p < 0.05$) in the type of compensation recommendation (COMP) a tax professional made in relation to the level of client advocacy (ADV) that a tax professional displays. The ambiguous tax scenario presented in this study regarding compensation of officer-shareholders in S corporations, specifically in relation to advocacy, has not been studied in prior known research. However, general advocacy and tax professionals' recommendations have been studied in past research. This finding is inconsistent with those studies, which suggests that tax professionals will make more aggressive recommendations when they exhibit higher levels of client advocacy (see Ayres et al., 1989; Helleloid, 1989; Johnson, 1993; Spilker et al., 1999 Stephenson, 2007).

Hypothesis H_B

The second research hypothesis relates to tax professional recommendations and client risk levels.

H_{1B}: Tax professionals will make more (less) aggressive recommendations for officer-shareholder compensation for S corporation clients considered low (high) risk.

This study did not find any significance ($p < 0.05$) in the type of compensation recommendation (COMP) a tax professional made in relation to clients who were considered high risk or low risk (RISK). The ambiguous tax scenario presented in this study regarding compensation of officer-shareholders in S corporations, specifically in relation to client risk, has not been examined in prior studies. Prior studies have researched client characteristics, namely client risk, and its relationship to tax professionals' recommendations. The finding from this study contradicts those prior research studies which suggests that for low (high) levels of client risk that tax professionals will recommend aggressive (non-aggressive) tax positions (see Duncan et al., 1989; Hackenbrack & Nelson, 1996; Kadous & Magro, 2001; Kadous et al., 2008).

Demographic Variables

Demographic variables were also examined in this study, which included years of tax experience (EXP), firm type (FIRM), the title within the firm (TITLE), gender (GENDER), education level (EDUC), and professional licensure/status (CPA).

Prior studies have found a link between experience and aggressive reporting (Helleloid, 1989; McGill, 1988). The findings in this research were inconsistent with past research. The years of tax experience variable (EXP) was not statistically significant

as a predictor for the compensation amount (COMP) recommendation made by tax professionals ($p < 0.05$).

The firm type variable (FIRM) has been investigated in past research. These studies have suggested that recommendations were different for tax professionals from different types of firms, and that tax professionals may be more aggressive who are employed by national firms (Helleloid, 1989; Stephenson, 2007). In this study, it was expected that recommendations from tax professionals would be different across different firm type categories. In this study's regression model, firm type (FIRM) was found to not be significant as a predictor for compensation (COMP) ($p < 0.05$). Additionally, an analysis of variance (ANOVA) revealed that the difference between each of the firm type (FIRM) categories was not statistically significant ($p < 0.05$). These results contradict prior research.

The variable, title of the tax professional (TITLE), was examined in this study as it relates to recommendations. This study found that the title of the tax professional (TITLE), as a predictor of compensation, was not statistically significant. Moreover, an ANOVA showed that the difference in categories of the title variable (TITLE) were not statistically significant ($p < 0.05$). This is inconsistent with prior research, which suggested a tax professional's title in a firm may influence recommendations, especially in instances where recommendations were client-favored (see Barrick et al., 2004; Chow et al., 1989; Hatfield, 2001).

Gender was a demographic variable (GENDER) in this study, and past studies have found that there are differences in risk aversion as it relates to gender. Prior research suggests that males are less risk averse than females, and males are more likely

to recommend client favored tax positions (see Bobek et al., 2010; Byrnes et al., 1999; Kelliher et al., 2001; McGill, 1988; Roberts, 1998; Sanders & Wyndelts, 1989). This study found that gender (GENDER), as a predictor of compensation (COMP), was not statistically significant ($p < 0.05$). An ANOVA revealed that the difference between recommendations made by males and females was not statistically significant ($p < 0.05$). These results contradict past research.

The education level of a tax professional (EDUC) was a demographic variable in this study. Past research reveals that education was significant with tax transaction knowledge, and more formal education was linked to more aggressive recommendations (Bonner et al., 1992; Carnes et al., 1996). In this study, education level (EDUC), as a predictor of compensation (COMP), was not statistically significant. Furthermore, an ANOVA suggested that the difference between the categories of the education variable (EDUC) was not statistically significant. These findings are inconsistent with prior research.

In prior research, professional status/licensure (CPA) has been studied in relation to a tax professional's decision making. This research indicated that Certified Public Accountants (CPAs) were more likely to advocate for their clients and make recommendations that were more pro-taxpayer than non-CPAs (Ayres et al., 1989). In this study, professional status (CPA), as a predictor of the compensation recommended (COMP), was not statistically significant ($p < 0.05$). Similarly, an ANOVA revealed that the differences between recommendations made by CPAs and non-CPAs were not statistically significant, which was inconsistent with prior research.

Conclusion

Interestingly, the findings of this study indicate that the amount of compensation a tax professional recommends for an officer-shareholder of an S corporation is not related to the level of client advocacy exhibited by the tax professional. This study also found that client risk is not related to the amount of compensation recommended by a tax professional. Little work has been done to examine the relationship between client advocacy, client risk, and S corporations' tax transactions, specifically determinations of compensation. While this study did not find statistical significance for client advocacy or client risk, it begins research on this topic.

These findings from this study suggest the need to examine other types of behaviors and client characteristics to determine significant predictors of compensation recommendations for S corporation officer-shareholders. This is important for the accounting profession since the construct of client advocacy is part of the professional standards upheld by tax professionals. If this construct has been found to not relate to recommendations for an increasingly complex tax position, what other constructs would be significant? These constructs and behaviors would be important for educational and training purposes of future tax accountants.

In this study, demographic variables were also examined in the regression model as they relate to the compensation recommendation. Demographic variables of the tax professionals surveyed included years of tax experience, firm type, gender, education level, and professional status/licensure. Results of the regression analysis found that the demographic variables were not significant predictors of officer-shareholder compensation. Additionally, one-way ANOVAs were performed to investigate each

grouping for the categorical and ordinal variables. These ANOVAs revealed that the categorical demographic variables did not have any significant difference among various groupings of the categorical and ordinal variables.

The results of this research present important findings for the accounting profession. This study suggests that demographic variables that have been commonly included in prior studies did not have statistical significance as they related to a recommended compensation amount. If these variables are not related to recommendations, what variables might be related? The results in this study suggest that it may benefit the accounting profession if research would identify such variables that relate to this type of recommendation since it is an ambiguous tax transaction that has garnered much examination in the last few decades. It would aide tax professionals for training and educational purposes, by recognizing how recommendations are made and how they are constructed.

Collectively, the findings from this study provide for a unique opportunity for the accounting profession to examine education and training programs. Training is such an integral part of the accounting profession, from the education requirements to sit for the CPA exam, to the importance of continuing education for all CPAs. These findings might suggest that more is to be done regarding advancing more thorough training and education at different levels and at different times throughout a tax professional's career. In conclusion, these findings give rise to areas for future research, which are discussed in a later section.

Limitations

There are five limitations associated with this research. These limitations, along with possible opportunities for future research, are presented below.

One limitation of this study relates to the final sample of the study. Participants for this study were from one state society of CPAs in the United States (U.S.). Consequently, the results and findings of this study may not be generalizable to the greater body of tax professionals in the United States (U.S.). An opportunity for future research is to extend this study to more tax professionals across the United States (U.S.).

A second limitation is related to several aspects of the experimental design of this research. It is difficult to make a connection between participants' answers with that of the actual behavior. However, according to the Theory of Planned Behavior, an individual's intentions and actual behavior may be linked when an individual is able to discern the control of such behaviors (Ajzen, 1991). Also, this study used one tax case in the survey instrument, and therefore, calls to question that the results of this research may be case-specific. To mitigate this limitation, a common, ambiguous tax research issue was relied upon (see Bobek et al., 2010).

A third limitation to this study stems from the experimental design relating to the construct, client risk. Client risk was an independent variable, which was manipulated in a between-subjects design. There were two possible experimental designs that participants could have encountered (high client risk or low client risk). Client risk was manipulated and operationalized as high or low based on the client facts presented in the hypothetical tax case (see Appendix B). These client characteristic outcomes were predetermined based on which survey the participant received. This is a limitation, such

that the participant was only given one set of facts describing the hypothetical client. However, this limitation also provides for another avenue of future research. This study could be conducted with both high and low risk outcomes compared simultaneously among participants.

Another limitation of this study pertains to the available participants that were a part of the study, as well as the length of the study. This study was developed to meet constraints around participation time, which may have had an impact on the results of the study. This may have affected response rate as well. In addition, there may have been participants who were not comfortable in answering those questions outlined in the survey.

Lastly, another limitation relates to some of the facts of the hypothetical tax case. Some features of the hypothetical tax payer and related business that were described were intentional to control for certain characteristics. The hypothetical taxpayer was part of a small company, not a larger company. This was a limitation to this study since larger firms were not a part of the results. However, this also presents an opportunity for future research. This study could be extended to examine recommendations made by tax professionals for a client that is a shareholder in a larger corporation.

Future Research

There are areas of potential future research that result from the findings of this study. One avenue of future research may focus on presenting this ambiguous issue to accountants who are not tax professionals. By studying another group of accountants other than tax professionals, new insight might be found regarding the results of this research and provide for opportunities to further enhance training of tax professionals.

Along this vein, this study could be extended to formulate comparisons between tax professionals and those individuals who are obtaining a degree in accounting/taxation. This would shed light on various teaching methods within an accounting program, training programs that new staff accountants receive at the beginning of their careers, and also how training might change for those that have been tax professionals for a number of years.

Another opportunity for future research lies with the constructs used in this study. Based on the findings of this research, client advocacy and client risk were not related to the amount of compensation recommended by tax professionals. Future research could further examine this to determine what other constructs influence the recommendations tax professionals make for this ambiguous tax transaction since client advocacy and client risk were related to recommendations made by tax professionals for another ambiguous tax transaction in past studies (see Bobek et al., 2010).

A third potential area of future research might focus on why the results of this research were inconsistent with past studies. Specifically, demographic variables were found to be not statistically significant in this study, which was contradictory to prior research findings. Future research could examine these demographics to see if there are explanations for why there seemed to be no difference in different demographic groupings in the results of this research.

Summary

In this study, client advocacy and client risk were not statistically significant in relation to the compensation recommendation made, but this study brings to light that additional research is needed to provide a better understanding of how a tax professional

makes recommendations for an ambiguous tax transaction. It is important that more research follows in this area since S corporations are an integral part of our United States (U.S.) economy as a small business structure. This ambiguous tax area has been tried in many court systems, possibly due to the lack of training and lack of access to proper tools to make such recommendations. As tax professionals, and the broader accounting profession, seek to continue the restoration of confidence of the public, it is imperative that tax professionals are trained to recognize ambiguous tax transactions and how to handle such transactions. With the complexity of our current tax system, it is inevitable that tax transactions will increasingly become more ambiguous.

Appendices

Appendix A

Mason and Levy (2001) Advocacy Scale

Question 1
In an instance where no judicial authority exists with respect to an issue and where the Code and Regulations are ambiguous, I feel that the taxpayer is entitled to take the most favorable tax treatment.

1	2	3	4	5	6	7
Strongly Disagree			Neutral			Strongly agree

Question 2
Generally speaking, my loyalties are first to the tax system, then to the taxpayer.

1	2	3	4	5	6	7
Strongly Disagree			Neutral			Strongly agree

Question 3
I feel I should apply ambiguous tax law to the taxpayer's benefit.

1	2	3	4	5	6	7
Strongly Disagree			Neutral			Strongly agree

Question 4
When examining a tax return, I tend to point out to taxpayers reasonable positions they could have taken which would have contributed to minimizing their tax liability.

1	2	3	4	5	6	7
Strongly Disagree			Neutral			Strongly agree

Question 5
I believe it is important that I encourage the taxpayer to pay the least amount of taxes possible.

1	2	3	4	5	6	7
Strongly Disagree			Neutral			Strongly agree

Appendix A (continued)

Question 6
I always interpret unclear/ambiguous laws in favor of the taxpayers.

1	2	3	4	5	6	7
Strongly Disagree			Neutral			Strongly agree

Question 7
It is important to use trends in the law by trying to establish a pattern of more favorable treatment for the taxpayer and then extending this pattern to the taxpayer's position.

1	2	3	4	5	6	7
Strongly Disagree			Neutral			Strongly agree

Question 8
Where no authority exists with respect to an issue, I feel that the taxpayer is entitled to take the most favorable tax treatment.

1	2	3	4	5	6	7
Strongly Disagree			Neutral			Strongly agree

Question 9
The taxpayer has the right to structure transactions in ways that yield the best tax result, even if the law is unclear in an area.

1	2	3	4	5	6	7
Strongly Disagree			Neutral			Strongly agree

Appendix B

Tax case scenario

Sam Smith opened an aquarium maintenance store on January 1, 2012. In addition to providing aquarium set-up and maintenance, the business also sells products for aquariums (i.e. fish, corals, rocks, tanks, maintenance supplies, etc.). The business was incorporated at its inception, and Sam, the sole-shareholder, has elected S corporation status.

The business, Aquarium Maintenance, Inc., is a small business corporation as defined by IRC §1361. This allows the business to elect S corporation status, as its sole shareholder is an individual, it has less than 100 shareholders, it has one class of stock, and it is a domestic corporation.

As the sole shareholder, Sam is also the president of the company. Currently, Sam performs all the servicing and set-up of all aquariums. In addition, he runs the day-to-day operations of the business, which includes maintaining the financial records of the business, marketing and public relations, tracking customers and collecting payments (accounts receivable), and paying vendors (accounts payable). Sam works at least 40 hours a week to accomplish all these responsibilities. The company's total assets are $300,000, net revenue is $600,000, and net income for 2012 is $26,250. Return on Equity (ROE) for the company is 15%.

For this first year of operations, the company has invested all available cash flow back into the business. Sam has not taken a salary in 2012 for his services. Instead, he has withdrawn funds, in the form of distributions, to cover his personal expenses, when cash is available. His cumulative distributions do not exceed his basis in the business, and they totaled $20,000 for 2012. Sam has heard that, because the corporation has elected S corporation status, he will need to pay himself a salary. He has asked you to help him determine a reasonable salary.

The issue at hand for you to determine and recommend is a reasonable salary for Sam to pay himself, beginning in 2013. Sam would then receive fewer distributions. Your firm has prepared Form 1120S for Sam for tax year 2012 and will be preparing Form 1120S for tax year 2013.

There is limited authoritative guidance on reasonable compensation for an S corporation officer-shareholder. However, there is no guidance on an absolute definition (or exact amount) of what constitutes reasonable compensation. Treas. Reg. § 31.3121(d)-1(b) states that an officer of the corporation is considered an employee of the corporation, unless the officer does not provide substantial services. Also, CP261, which is the IRS notice for acceptance of S corporation status, specifically outlines the tax requirements for S corporation officer-shareholder compensation. Lastly, IRS fact sheet FS-2008-25 identifies a number of factors that can be used to determine reasonable compensation. Excerpts from the above mentioned regulations and documents are provided next to aid you in your recommendation.

Appendix B (continued)

Manipulation of client facts

Low risk manipulation.
Sam and Sally Smith are high-income taxpayers. The firm prepares their personal tax returns each year. The Smiths are cooperative clients and avoid using tax saving strategies as much as possible. Their records are strong, always in order, and transactions are well-documented. In addition, the Smiths have not had any previous IRS audits.

High risk manipulation.
Sam and Sally Smith are high-income taxpayers. The firm prepares their personal tax returns each year. At times, the Smiths can be uncooperative and suggest tax saving strategies whenever possible. Their records are mostly incomplete, and when present, their records are weak in documentation. They have also had previous IRS audits, and these audits have resulted in sizable adjustments, which have led to substantial penalties and interest.

Appendix C

Demographic Variables

1. What is your gender?
   Male
   Female

2. Are you currently working in public accounting?
   Yes
   No

3. What is your current practice type?
   Tax
   Audit
   Industry
   Education
   Consulting
   Other

4. Question dependent on answer from previous question.
   a. Tax – how many years of tax experience do you have?
   b. All others – have you ever practiced tax before?
      i. Yes- how many years ago? How many years tax experience do you have?
      ii. No

5. In years, how long have you worked in public accounting?
   0-5
   6-10
   11-15
   16-20
   21-25
   26-30
   30+

6. What is your current or most recent firm type?
   Local (50 employees or less, and 1 office)
   Regional (50+ employees, and 5 or more offices)
   National/Big 4
   International (at least 1 office in 2 different countries)

Appendix C (continued)

7. Please choose one of the following to indicate your current or most recent role in your firm.
   Staff
   Senior Staff
   Senior
   Manager
   Director
   Principal/Partner

8. What is the highest education level that you have achieved?
   No degree
   High school degree
   Bachelor's degree
   Master's degree
   Doctorate degree

9. Are you a licensed CPA?
   Yes
   No

   9a. If yes, sub-question: Active CPA or inactive CPA

   9b. If no, sub-question: Passed exam, awaiting certification; exam not yet passed; do not intend to take exam; licensed other – choices CMA, CIA, Attorney, Other

Appendix D

Human Subjects Committee Approval

ANDERSON UNIVERSITY

June 22, 2015

Laura Lachmiller
437 Nora Drive
Perrysburg, OH 43551

Dear Laura,

Regarding your request for approval to conduct research using human subjects: The DBA Human Subjects Committee has reviewed your proposed questionnaire and your method for gathering information for your dissertation entitled,

"The Relationship of Client Advocacy and Client Risk on Shareholder Compensation Recommendations for S Corporations"

After discussing your request and reviewing the current version of your survey instrument, the DBA Human Subjects Committee **approves** your request to continue the conducting of your research.

You will need to continue to respond to editing and methodological requirements of your chair as well as other members of your dissertation committee.

Should the need arise for you to significantly modify your data gathering process then you will need to resubmit a request to the DBA Human Subjects Committee.

We wish you well as you progress towards the completion of your dissertation and your DBA degree.

Sincerely,

Doyle J. Lucas, Ph. D.
DBA Program Director

Appendix E

Email to Participants

Greetings to everyone,

My name is Laura Lachmiller, and I am a graduate student at Anderson University, IN, pursuing my doctorate degree. I have been a member of the Ohio Society since I was a sophomore in college. My undergraduate and graduate degrees are in accounting, and I began my career as an auditor. Shortly after receiving my CPA license, I went to work for a small local firm in Toledo, Ohio, where I began working as a tax accountant. For a few years, I taught accounting courses part time at The University of Toledo. In 2012, I began teaching accounting and tax courses as a full-time instructor for Bowling Green State University. My interests have always been taxation and education; with the completion of my doctorate degree, I will be able to continue to pursue both of these!

In the past year, I have been writing my dissertation, which is the final piece in completing my degree. For my dissertation, I am researching the relationship between client advocacy, client-based risks, and a tax professional's recommendation on an ambiguous tax transaction. You are receiving this email as an invitation to participate in this study. As such, I have provided a link to a survey that will better help us understand how these interact and the magnitude that they interact, and I believe that your voice is critical to my research. Your thoughtful answers will be used in dissertation results, future papers, and future research. They will provide valuable information to practitioners, academics, and regulators alike.

Because those of us in the accounting profession lead busy lives, the survey has been constructed to only take about 15 minutes to complete. Your responses will be completely anonymous. Neither your name nor IP address will be collected or associated in any way with your responses, and only aggregated data will be included in any resulting publications or presentations. In recognition of your valuable time and answers, once you have completed the survey, you can submit your email address to enter a drawing to win one of four gift cards to Amazon.com.

You can access the survey now by clicking on the following link:
https://www.surveymonkey.com/r/VCCNTN7

The survey will be open until Friday, December 18 at midnight.

I thank you in advance for taking the time to be a part of this important survey! If you have difficulty accessing or submitting the survey, please email me at Lachmiller@yahoo.com or call me at 419-873-5727.

Best Regards,

Laura J. Lachmiller, CPA

Appendix F

Response Distributions for Scale Items Demographics

Table F1

Advocacy Scale Items: Count, Percentages, Mean, and Standard Deviation:

	1 Strongly disagree		2		3		4 Neutral		5		6		7 Strongly Agree		Mean	Standard Deviation
	Count	%	Count	%	Count	%	Count	%	Count	%	Count	%	Count	%		
Question 1: In an instance where no judicial authority exists with respect to an issue and where the Code and Regulations are ambiguous, I feel that the taxpayer is entitled to take the most favorable tax treatment.	5	2.38%	3	1.43%	15	7.14%	33	15.71%	71	33.81%	50	23.81%	33	15.71%	5.11	(1.35)
Question 2: Generally speaking, my loyalties are first to the tax system, then to the taxpayer. (Item is reverse-coded.)	17	8.10%	20	9.52%	25	11.90%	51	24.29%	37	17.62%	37	17.62%	23	10.95%	4.31	(1.74)
Question 3: I feel I should apply ambiguous tax law to the taxpayer's benefit.	11	5.24%	14	6.67%	16	7.62%	37	17.62%	76	36.19%	37	17.62%	30	14.29%	4.65	1.57
Question 4: When examining a tax return, I tend to point out to taxpayers reasonable positions they could have taken which would have contributed to minimizing their tax liability.	0	0.00%	3	1.43%	3	1.43%	13	6.19%	31	14.76%	85	40.48%	75	35.71%	5.99	(1.06)
Question 5: I believe it is important that I encourage the taxpayer to pay the least amount of taxes possible	10	4.76%	21	10.00%	30	14.29%	41	19.52%	46	21.90%	37	17.62%	25	11.90%	4.43	(1.69)
Question 6: I always interpret unclear ambiguous laws in favor of the taxpayer.	8	3.81%	12	5.71%	30	14.29%	65	30.95%	53	25.24%	33	15.71%	9	4.29%	4.32	(1.37)
Question 7: It is important to use trends in the law by trying to establish a pattern of more favorable treatment for the taxpayer and then extending this pattern to the taxpayer's position.	2	0.95%	6	2.86%	13	6.19%	49	23.33%	79	37.62%	43	20.48%	18	8.57%	4.90	(1.20)
Question 8: Where no authority exists with respect to an issue, I feel that the taxpayer is entitled to take the most favorable tax treatment.	3	1.43%	4	1.90%	10	4.76%	32	15.24%	77	36.67%	59	28.10%	25	11.90%	5.16	(1.22)
Question 9: The taxpayer has the right to structure transactions in ways that yield the best tax result, even if the law is unclear in an area.	6	2.86%	9	4.29%	25	11.90%	31	14.76%	76	36.19%	38	18.10%	25	11.90%	4.79	(1.45)

Table F2

Client Risk Assessment Scale Item

Client risk assessment question in survey instrument:

Client risk represents the risk of certain costs, monetary and nonmonetary, that tax professionals must face when advising clients. Monetary costs associated with this type of risk are litigation costs, preparer penalties, legal fees, and possible additional amounts owed to the client. Nonmonetary costs may include damage of reputation, sanctions imposed by professional organizations and accountancy boards, and criticism of work. In describing the hypothetical client, how much client risk was created relative to other clients at your firm?

	1 Strongly disagree		2		3		4 Neutral		5		6		7 Strongly Agree		Mean	Standard Deviation
	Count	%	Count	%	Count	%	Count	%	Count	%	Count	%	Count	%		
High Client Risk Experimental Condition	0	0.00%	6	8.45%	4	5.63%	11	15.49%	28	39.44%	17	23.94%	5	7.04%	4.86	(1.29)
Low Client Risk Experimental Condition	7	5.04%	27	19.42%	14	10.07%	66	47.48%	22	15.83%	2	1.44%	1	0.72%	3.57	(1.20)

ANOVA analysis summary:

Source	DF	F-value	P-value
Client risk	1	49.32	0.000

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