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S CORPORATION COMPENSATION RECLASSIFICATION RISKS

Presented By:

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I. INTRODUCTION

A. CHOICE OF ENTITY STATISTICS

Although LLCs have gained increasing popularity over the last decade, the number of entities taxed as S corporations still exceeds the number of entities taxed as partnerships for federal tax purposes, and it is projected to stay that way for the foreseeable future, as set forth in the table below published by the IRS (Document 6292, Office of Research, Analysis and Statistics, Fiscal Year Return Projections for the United States: 2012-2019, Rev. 6/2012):

Statistics Regarding Choice of Entity

	2011 (Actual)	**2012 (Projected)**	**2016 (Projected)**	**2019 (Projected)**
Form 1065	3,573,550	3,604,400	3,963,400	4,232,700
Form 1120S	4,545,454	4,603,700	5,582,000	6,098,600
Form 1120	1,965,523	1,902,900	1,107,600	1,167,000

B. DOUBLE TAX ON EARNINGS OF C CORPORATION DISTRIBUTED AS DIVIDENDS TO SHAREHOLDERS

Although many existing "C" corporations have converted to S corporation status (or other form of passthrough entity) and most new entities have been formed as some type of passthrough entity (S corporation, LLC or partnership), many professional and other personal service corporations have remained C corporations based on the assumption that they can successfully avoid the double tax on earnings to which C corporations are generally subject by utilizing the strategy of zeroing out their taxable income by payment of all or substantially all of their earnings as deductible compensation to their shareholder-employees. It has been widely accepted in the past by practitioners and taxpayers that the IRS cannot successfully assert unreasonable compensation arguments against a personal service corporation to recharacterize a portion of the compensation paid to its shareholder-employees as dividend distributions. However, in light of the application of the "independent investor test" by the Tax Court and the Sixth Circuit Court of Appeals in *Mulcahy, Pauritsch, Salvador & Co.*, 680 F.3d 867 (7th Cir. 2012)., and the Tax Court's prior decision in *Pediatric Surgical Associates, P.C. v. Comm'r*, TCM 2001-81, tax practitioners must recognize that the IRS can make a successful argument to recharacterize the wages paid to the shareholders-employees of a personal service corporation as dividends subject to double taxation.

C. DOUBLE TAX ON SALE OF ASSETS OF C CORPORATION

Likewise, most entities have either converted from "C" status to "S" status or to some other form of passthrough entity or been formed as a passthrough entity to avoid the double tax on the sale of assets to which "C" corporations are subject. However, in order to avoid double taxation on the sale of a professional or other service corporation's assets to a third party, tax practitioners have often sought to avoid the double tax imposed upon C corporation's selling their assets by allocation of a large portion of the purchase price to the "personal goodwill" of the shareholders of the professional corporation. Although this strategy has worked under certain circumstances, very recent cases have suggested that the IRS can and will recharacterize so-called personal goodwill as corporate goodwill subject to double taxation (or at the least to ordinary income tax rates rather than capital gain tax rates) on the sale of the assets of a professional corporation.

II. UNREASONABLY HIGH COMPENSATION AND C CORPORATIONS

A. LAW

The relevant authority in this area is Section 162(a)(1), which allows a deduction for ordinary and necessary expenses paid or incurred during a taxable year in carrying on a trade or business, including a "reasonable allowance" for salaries or other compensation for personal services actually rendered.

Reg. §1.162-7(a) provides that the test of deductibility in the case of compensation payments is whether such payments are reasonable ***and*** are, in fact, payments purely for services. Consequently, there is a two-prong test for the deductibility of compensation payments: (1) whether the amount of the payment is ***reasonable*** in relation to the services performed, and (2) whether the payment was, in fact, ***intended*** to be compensation for services rendered.

Reg. §1.162-7(b)(1) additionally provides that any amount paid in the form of compensation, but not in fact as the purchase price of services, will ***not*** be deductible. The regulation continues as follows: "An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock."

Reg. §1.162-7(b)(2) provides that the form or method of fixing compensation will not be decisive as to deductibility. The regulation continues that although any form of contingent compensation invites scrutiny as a possible distribution of earnings of the corporation, it does not necessarily follow that payments on a contingent basis will be treated fundamentally on any basis different than that applying to compensation at a flat rate.

Reg. §1.162-7(b)(3) provides that "the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."

Reg. §1.162-8 provides that in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholders, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend.

Reg. §1.162-9 provides that bonuses to employees will constitute allowable deductions from gross income if such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to salaries, do not exceed a reasonable compensation for the services rendered.

As discussed above, the regulations set forth a two-prong test for the deductibility of compensation payments: (1) whether the amount of payment is reasonable in relation to the services performed, and (2) whether the payment was, in fact, intended to be compensation for services rendered. Although a majority of the cases focus on the reasonableness of the compensation paid, and do not focus separately on the intent of the payment, several cases have discussed the intent requirement.

B. COMPENSATORY INTENT

In determining whether the payment was intended to be compensation for services rendered, the courts have relied heavily on the initial characterization of the payment by the corporation and have focused on such objective criteria as whether the board of directors authorized the payment of the compensation in question, whether employment taxes were withheld from the payment, whether a Form W-2 was issued with regard to the payment in question, and whether the payment was deducted on the accounting records or tax records of the corporation as salary.

The leading case in this area is *Paula Construction Co. v. Comm'r*, 58 TC 1055 (1972), *aff'd per curiam*, 474 F.2d 1345, 73-1 USTC ¶9283 (5th Cir. 1973). In *Paula Construction*, the shareholder-employees believed that the corporation's Subchapter S status was in effect (it had been inadvertently and retroactively terminated for the years in issue), and as such, did not reflect the corporation's distributions as compensation in the corporate records or its tax returns as it believed such distributions would be nontaxable distributions from the S corporation to its shareholders. In holding that the corporation was not entitled to a compensation deduction for the amounts paid, the Tax Court stated that "it is now settled law that only if payment is made with the intent to compensate is it deductible as compensation. ... Whether such intent has been demonstrated as a factual question is to be decided on the basis of the particular facts and circumstances of the case." See also *Electric & Neon v. Comm'r*, 56 TC 1324 (1971), *aff'd per curiam*, 496 F.2d 876, 74-2 USTC ¶9542 (5th Cir. 1974), and *International Capital Holding Corp. v. Comm'r*, TCM 2002-109, in which the Tax Court found that payments made to a management company were intended to compensate the recipient for services rendered. Since the IRS conceded the reasonableness of the amount paid, the payments were found to be deductible. But see *Neonatology Associates P.A., et al. v. Comm'r*, 2002 USTC ¶50,550 (3rd Cir. 2002), *aff'g* TCM 2001-270, where the Third Circuit affirmed the Tax Court in three cases on VEBA deductions by medical corporations, holding that the corporations could not deduct payments made to the VEBAs since the VEBAs were not designed to provide benefits to employees, but were instead intended to benefit the sponsoring owners of the VEBAs, and treating the payments as constructive dividends. These cases make it clear that it is absolutely necessary to properly document payments made by a corporation to its shareholder-employees as compensation (rather than as dividend distributions) in order for the payments to be deductible. *See also* IRS Field Service Advice, 1994 W.L. 1725566 (addressing compensatory intent in the context of a law firm); IRS Field Service Advice, 1995 W.L. 1918240; IRS Field Service Advice 200042001; GCM 36801 (1976); and *Nor-Cal Adjusters v. Comm'r,* 74-2 USTC ¶9701 (9th Cir. 1974).

C. REASONABLENESS OF COMPENSATION AND THE MULTI-FACTOR TEST

The leading case in the unreasonable compensation area is *Mayson Manufacturing Co. v. Comm'r*, 178 F.2d 115, 49-2 USTC ¶9467 (6th Cir. 1949), which sets forth nine factors to be used in evaluating the reasonableness of the amount of an employee's compensation. These factors have generally been used in one form or another in almost all subsequent cases analyzing the reasonableness of compensation.

The nine factors set forth in the *Mayson* case are as follows:

1. the employee's qualifications,

2. the nature, extent, and scope of the employee's work,

3. the size and complexities of the business,

4. a comparison of the salaries paid with the gross income and the net income of the business,

5. the prevailing general economic conditions,

6. a comparison of salaries with distributions to stockholders,

7. the prevailing rates of compensation for comparable positions and comparable businesses,

8. the salary policy of the taxpayer for all employees,

9. the compensation paid to the particular employee in prior years where the business is a closely-held corporation.

Another significant case utilizing the multi-factor test is *Elliotts Inc. v. Comm'r*, 716 F.2d 1241, 83-2 USTC ¶9610 (9th Cir. 1983), *rev'g* TCM 1980-282. *Elliotts* involved a corporation that sold and serviced equipment manufactured by John Deere Company and other manufacturers. The taxpayer's sole shareholder, Edward G. Elliotts, was found to have total managerial responsibility for the taxpayer's business and was the ultimate decision and policy maker and, in addition, performed the functions usually delegated to sales and credit managers. He worked approximately 80 hours each week.

The taxpayer had compensated Elliotts by paying a base salary plus a year-end bonus, which, since incorporation, had been fixed at 50% of net profits (before deduction for taxes and management bonuses). On audit of the 1975 and 1976 tax years, the IRS determined that a portion of the compensation paid to Elliotts was unreasonable in amount.

After reviewing the testimony and statistical evidence presented by the parties, the Tax Court concluded that the payments to Elliotts, in addition to providing compensation for personal services, were intended in part to distribute profits and were, therefore, nondeductible dividends.

The taxpayer appealed the Tax Court's determination to the Court of Appeals for the Ninth Circuit. The Ninth Circuit's opinion is important for three main reasons. First, the Ninth Circuit recognized that in analyzing the two-prong test for deductibility under Section 162(a)(1), a taxpayer's proof that the amount paid is reasonable will often result in similar proof that the purpose for which the payments are made is compensatory.

The second reason *Elliotts* is important is that the court rejected any requirement that a profitable corporation should use part of its earnings to pay dividends. First, the court stated that no statute requires profitable corporations to pay dividends. Second, any such requirement is based on the faulty premise that shareholders of a profitable corporation will demand dividends. Third, it may well be in the best interest of the corporation to retain and invest its earnings.

Although the first two issues outlined above are important, *Elliotts* is probably more important for categorizing the nine *Mayson* factors discussed above into the following five categories:

1. The employee's role in the company, including as relevant to such consideration the position held, hours worked and duties performed by the

employee, in addition to the general importance of the employee to the success of the company.

2. An external comparison of the employee's salary with those paid by similar companies for similar services. Thus, if a shareholder is performing the work of three employees, for example, the relevant comparison would be the combined salaries of those three employees in a similar corporation.

3. The character and condition of the company as indicated by its sales, net income, and capital value, together with the complexities of the business, as well as general economic conditions.

4. Whether some relationship exists between the corporation and its shareholder-employee which might permit the company to disguise nondeductible corporate distributions of income as salary expenditures deductible under Section 162(a)(1). This category employs the independent investor standard, which provides that if the company's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company as disguised salary.

5. A reasonable, long-standing, consistently applied compensation plan is evidence that the compensation paid for the years in question is reasonable.

In addition to the factors established by the courts, the IRS has developed its own factors set forth in the Internal Revenue Manual, I.R.M. 4233, Part IV, Examination, at Section 4.3.1.5.2.5.2.2. *See also* Martin and Harris, "Unreasonable Compensation: *Pediatric Surgical* Poses a Major New Threat for PCs," 97 J. Tax'n 41 (July 2002). The favorable factors (indicative of a finding of reasonable compensation) listed in prior versions of the Internal Revenue Manual include the following:

1. long hours,

2. uniqueness of the employee's contribution,

3. success in turning the company around,

4. the company's above-average growth or profitability,

5. experience level of the employee,

6. high productivity and effectiveness of the employee,

7. bonus arrangements entered into prior to becoming a stockholder,

8. whether the employee was offered a higher salary by outsiders,

9. inability of the employee to control compensation levels or dividends,

10. salary compared favorably with that of employees of other companies,

11. employee was undercompensated in previous years, and

12. high return on equity.

Unfavorable factors (indicative of a finding of unreasonable compensation) listed in prior versions of the Internal Revenue Manual) include the following:

1. compensation rate exceeded that of comparable companies,

2. lack of dividend payments,

3. inappropriate compensation formulas,

4. lack of unique employee skills,

5. employee spent little time on the job or worked less than in previous years,

6. the board of directors was not independent,

7. salary increased without increase in duties, and

8. bonus formulas changed because of high profits.

Reg. §1.162-7(b)(1) and §1.162-8 provide that it is likely that a compensation payment is in fact a dividend distribution where excessive payments correspond or bear a close relationship to the recipient's stock holdings in the company. The "automatic dividend" rule set forth in *Charles McCandless Tile Service v. U.S.*, 422 F.2d 1336, 70-1 USTC ¶9284 (Ct. Cl. 1970), was rejected by the *Elliotts* case discussed above as well as by the IRS in Rev. Rul. 79-8. 1979-1 CB 92. Although there is no automatic dividend rule, the dividend history of the corporation and whether the compensation (bonuses) is paid in proportion to the stock ownership of the shareholder-employees are important factors in the multi-factor test. The fact that compensation payments are not made in proportion to the shareholder-employee's stock ownership does not, however, preclude a finding that the compensation payment actually constituted a dividend. *See Kennedy v. Comm'r*, 671 F.2d 167, 82-1 USTC ¶9186 (6th Cir. 1982), *rev'g and remanding*, 72 TC 793 (1979).

D. <u>REASONABLENESS OF COMPENSATION AND THE INDEPENDENT INVESTOR TEST</u>

1. **<u>Background</u>**. The Independent Investor Test. In the *Elliotts* case, the five factors used by the court in determining the reasonableness of compensation paid by the corporation to its shareholder-employees employed an independent investor standard. That standard provides that if the corporation's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company as disguised salary. This is referred to as the "independent investor test."

   In *Dexsil Corp. v. Comm'r*, 147 F.3d 96, 98-1 USTC ¶50,471 (2nd Cir. 1998), the Second Circuit vacated and remanded a decision of the Tax Court finding unreasonable employee compensation in the context of a closely held corporation. In reaching its decision, the court quoted its opinion in *Rapco Inc. v. Comm'r*, 85 F.3d 950, 96-1 USTC ¶50,297 (2nd Cir. 1996), in stating that "in this circuit the independent investor test is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed," 147 F.3d at 101. The court thus articulated the notion that the independent investor tests is more than a mere factor in determining the reasonableness of compensation and provides the very basis for assessing reasonableness.

   Other circuits have adopted the independent investor test as set forth by the Second Circuit in *Dexsil*. In *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 99-2 USTC ¶50,964 (7th Cir. 1999), the Seventh Circuit held that the salary paid to a shareholder-employee was reasonable based on the fact that an independent investor would achieve a high rate of return even with the shareholder's salary. In following the *Dexsil* court's reasoning, Chief Judge Posner stated that "[b]ecause judges tend to downplay the element of judicial creativity in adapting law to fresh insights and changed circumstances, the cases we have just cited [*Dexsil* and *Rapco*] prefer to say ... that the 'independent investor' test is the 'lens' through which they view the seven ... factors of the orthodox test. But that is a formality. *The new test dissolves the old and returns the inquiry to basics*."

2. **<u>The *Menard* Case</u>**. In *Menard, Inc. v. Comm'r*, 560 F.3d 620 (7th Cir. 2009), the Seventh Circuit reversed the holding of the Tax Court and found that the compensation paid by a corporation to its chief executive officer constituted reasonable compensation rather than a non-deductible dividend distribution to him.

   Menard, Inc. is a Wisconsin firm that under the name "Menard's" sells hardware, building supplies and related products through retail stores scattered throughout the Midwest. In 1998, it was the third largest home improvement chain in the United States, with only Home Depot and Lowe's being larger. It was founded by John Menard in 1962, who through 1998 was the company's chief executive officer and uncontradicted evidence shows him as working 12 to 16 hours a day six or seven days a week and only taking seven days of vacation per year. Under his management, Menard's revenues grew from $788,000,000 in 1991 to $3,400,000,000 in 1998 and the company's taxable income grew from $59,000,000 to $315,000,000 during the same time period. The company's rate of return on shareholders' equity in 1998 was, according to the IRS's expert, 18.8%, which was higher than the rate of return on shareholders' equity for either Home Depot or Lowe's.

Mr. Menard owned all of the voting shares in the company and 56% of the non-voting shares, with the rest of the shares being owned by members of his family. In 1998, his salary was $157,500, and he received a profit-sharing bonus of $3,017,100 as well as a "5% bonus" that resulted in Mr. Menard receiving an additional $17,467,800.

The 5% bonus program (5% of the company's net income before income taxes) was adopted in 1973 by the company's Board of Directors at the suggestion of the company's accounting firm. There was no suggestion that any shareholder was disappointed that the company obtained a rate of return of only 18.8% or that the company's success in that year or any other year had been due to windfall factors. In addition to finding that Mr. Menard's compensation was excessive (primarily based on the compensation paid to the chief executive officers of Home Depot and Lowe's), the Tax Court found that such amounts were actually ***intended as a dividend***. The Tax Court reached this conclusion because Mr. Menard's entitlement to his 5% bonus was conditioned on his agreeing to reimburse the corporation if the deduction of the bonus from the corporation's taxable income was disallowed by the IRS and because 5% of the corporate earnings year-in and year-out looked more like a dividend than a salary to the Tax Court. As will be discussed in more detail below, the Seventh Circuit found that the Tax Court's holding was based on "flimsy grounds."

In reviewing the Tax Court decision, the Seventh Circuit pointed out that a corporation is ***not*** required to pay dividends. The main focus of the Tax Court decision was whether Mr. Menard's compensation exceeded that of comparable CEOs in 1998. Specifically, the CEO of Home Depot was paid only $2,800,000 in 1998, and the CEO of Lowe's was paid a salary of $6,100,000 in 1998 (both of which were considerably less than the total compensation paid to Mr. Menard in 1998 of over $20,000,000).

The Seventh Circuit found that salary is just the beginning of a meaningful comparison, because it is only one element of a compensation package. Specifically, the Seventh Circuit pointed out that a risky compensation structure implies that the executive's salary is likely to vary substantially from year to year, and that Mr. Menard's compensation could have been considerably less than $20,000,000 if the corporation did not have a good year, a possibility the Tax Court completely ignored. Additionally, the Seventh Circuit found that the Tax Court did not consider the severance packages, retirement plans or other perks of the CEOs when it compared Menard with the CEOs of Home Depot and Lowe's. The Seventh Circuit also found that the Tax Court's opinion strangely remarked that because Mr. Menard owned the company he had all the incentive he needed to work hard without the need for a generous salary. The Seventh Circuit pointed out that under the Tax Court's reasoning, reasonable compensation for Mr. Menard might have been zero. In short, the Seventh Circuit found that for compensation purposes, the shareholder-employee should be treated like all other employees and that if an incentive bonus is appropriate for a non-shareholder employee, there is no reason why a shareholder-employee should not be allowed to participate in the same manner. Based on these considerations and the fact that an independent investor would be satisfied with an 18.8% rate of return, the Seventh Circuit concluded that Mr. Menard's compensation was *not* excessive in 1998, and that the Tax Court committed clear error in finding that Mr. Menard's compensation was unreasonable.

3. **The *Multi-Pak Corp.* Case**. In *Multi-Pak Corp. v. Comm'r,* TCM 2010-139, the Tax Court held that the compensation paid by the taxpayer's wholly owned corporation for one of the years in issue (2002) was reasonable, but recharacterized a portion of the compensation paid to the taxpayer in the other year in issue (2003) as a non-deductible dividend distribution because the amount of compensation paid to the taxpayer in that year was unreasonable.

The taxpayer, Multi-Pak Corp., was a C corporation wholly owned by Randall Unthank, who was the president, CEO and COO for the years in issue. Mr. Unthank performed all of Multi-Pak's managerial duties and made all personnel decisions, and was in charge of Multi-Pak's price negotiations, product design, machine design and functionality, and administration. Mr. Unthank also personally oversaw the expansion of Multi-Pak's office and warehouse in order to accommodate Multi-Pak's growing operations.

In 2002, Multi-Pak paid total compensation of $2,020,000 to Mr. Unthank, consisting of a salary of $150,000 and a $1,870,000 bonus. In the other year at issue, 2003, Multi-Pak paid a total compensation of $2,058,000 to Mr. Unthank, consisting of a salary of $353,000 and a $1,705,000 bonus. The IRS determined in a Notice of Deficiency that Multi-Pak could deduct only $665,000 and $660,000 of officer compensation for 2002 and 2003, respectively, as reasonable compensation for Mr. Unthank's services during those years. Additionally, the IRS imposed Section 6662(a) accuracy-related penalties on Multi-Pak for the years in issue.

In reaching its decision, the court in *Multi-Pak* discussed and analyzed the five categories previously set forth in the *Elliotts* case:

a. ***The employee's role in the company, including as relevant to such consideration the position held, hours worked and duties performed by the employee, in addition to the general importance of the employee to the success of the company***. In Multi-Pak, the Tax Court found that this factor favored the taxpayer based upon Mr. Unthank's importance to Multi-Pak.

b. ***An external comparison of the employee's salary with those paid by similar companies for similar services. Thus, if a shareholder is performing the work of three employees, for example, the relevant comparison would be the combined salaries of those three employees in a similar corporation***. After an extensive analysis of the expert testimony presented by the taxpayer and the IRS, the Tax Court in Multi-Pak found that the analysis performed and the opinions expressed by both parties' experts were not persuasive or reliable, and as such, found that the comparison to the compensation paid by unrelated firms was a neutral factor which did not favor either party.

c. ***The character and condition of the company as indicated by its sales, net income, and capital value, together with the complexities of the business, as well as general economic conditions***. The Tax Court found that although Multi-Pak's net income in 2002 and 2003 was low when compared to revenues, other factors such as equity, revenue, and gross profit pointed towards a successful operation, and as such, found that this factor favored the taxpayer.

d. ***Whether some relationship exists between the corporation and its shareholder-employee which might permit the company to disguise nondeductible corporate distributions of income as salary expenditures deductible under Section 162(a)(1)***. This category employs the independent investor standard, which provides that if the company's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company as disguised salary. As will be discussed in more detail below, the Tax Court found that this factor favored the taxpayer in 2002 but favored the IRS in 2003.

e. ***A reasonable, long-standing, consistently applied compensation plan is evidence that the compensation paid for the years in question is reasonable***. The Tax Court found that in 2002 and 2003, Mr. Unthank paid himself a monthly bonus of $100,000 to $250,000 in 19 of the 24 months, in four other instances, Mr. Unthank paid himself a bonus of $50,000 or less, and in one other instance paid himself a bonus of $375,000. Additionally, Mr. Unthank's sons each were paid monthly bonuses that ranged from zero to $90,000. Based on all these facts, the Tax Court concluded that the taxpayer's payment of Mr. Unthank's bonuses was made under a consistent business policy, and as such, this factor favored the taxpayer.

In determining the rate of return which would be received by the hypothetical independent investor, the Tax Court in *Multi-Pak* divided the taxpayer's net profit (after payment of compensation and a provision for income taxes) by the year-end shareholder's equity as reflected in its financial statements. This yielded a return on equity of 2.9% for 2002 and negative 15.8% for 2003. The court concluded that although an independent investor may prefer to see a higher rate of return than the 2.9% in 2002, they believed that an independent investor would note that Mr. Unthank was the sole reason for the company's significant rise in sales in 2002 and would be satisfied with the 2.9% rate of return. However, the court agreed with the IRS that a negative 15.8% return on equity in 2003 called into question the level of Mr. Unthank's compensation for that year. The court went on to state that when compensation results in a negative return on shareholder's equity, it cannot conclude, in the absence of a mitigating circumstance, that an independent investor would be pleased. Consequently, the court felt that if Mr. Unthank's salary was reduced to $1,284,104 in 2003, which would result in a return on equity of 10% in 2003, that would be sufficient to satisfy an independent investor. The court therefore held that taxpayer was entitled to deduct the full $2,020,000 paid by it to Mr. Unthank in 2002 and was entitled to deduct $1,284,104 out of the original compensation of $2,058,000 paid to Mr. Unthank in 2003.

Although the Tax Court did evaluate each of the five factors set forth in the *Elliotts* case, it seemed to rely primarily on the independent investor test in reaching its conclusions as to the reasonableness of the compensation paid to Mr. Unthank in 2002 and 2003.

Additionally, the court found that the taxpayer reasonably relied upon professional advice so as to negate a Section 6662(a) accuracy-related penalty because it met each of the following tests:

(1) The advisor was a competent professional who had sufficient expertise to justify reliance;

(2) The taxpayer provided necessary and accurate information to the advisor; and

(3) The taxpayer actually relied in good faith on the advisor's judgment.

(4) Thus, the Tax Court declined to sustain the IRS's determination as to the accuracy-related penalty.

4. **The *Mulcahy* Case - Independent Investor Test Applied to Professional Service Corporation**. In *Mulcahy, Pauritsch, Salvador & Co.*,[1] the Seventh Circuit Court of Appeals affirming the Tax Court, held that over $850,000 paid in each of the three years in issue to entities owned by each of the founding shareholders of an accounting firm operated as a C corporation should be recharacterized as nondeductible dividend distributions. The *Mulcahy* case represents the first case in which a court has applied the so-called "independent investor test" in determining reasonable compensation in the professional service corporation setting.

Under the facts of the case, an accounting firm operated as a C corporation, had 40 employees located in multiple branches, and, according to the court, had both physical capital and intangible capital (in the form of client lists and brand equity).

Although the corporation had revenues between $5 million to $7 million annually, the corporation itself had little or no income because its gross revenues were offset by deductions for business expenses, primarily compensation paid directly or indirectly to its owner-employees, which included three of the firm's accountants whose names form the name of the firm and owned more than 80% of the firm's stock (the "Founding Shareholders"). The firm reported taxable income of only $11,279 in 2001, a loss of $53,271 in 2002 and zero taxable income in 2003. In addition to the salaries received by the Founding Shareholders that totaled $323,076 in 2001, the corporation additionally paid more than $850,000 in "consulting fees" for each of the three years in issue to three entities owned by the Founding Shareholders, which in turn distributed the money to the Founding Shareholders.

The IRS did not question the salary deductions, but disallowed the consulting fees paid to the three entities owned by the Founding Shareholders as nondeductible dividends, resulting in a deficiency in corporate income tax of more than $300,000 for each of the three years in issue.

[1] 680 F.3d 867 (CA-7 2012).

The Seventh Circuit found that the accounting firm would flunk the independent-investor test if it were to treat the consulting fees as salary expenses, since they reduced the firm's income such that the return to a hypothetical equity investor of the corporation would be zero or below zero.

In its decision, the Seventh Circuit found that although the independent investor test may not be applicable to the "typical small professional services firm," the accounting firm in issue was not a very small firm because of its physical capital, numerous employees and intangible capital. Consequently, as stated above, the Seventh Circuit found that the Tax Court was correct to reject the firm's argument that the consulting fees were salary expenses because treating such expenses as salary reduced the firm's income, and thus the return to the hypothetical equity investor, to zero or below zero. The Seventh Circuit specifically found that there was no evidence that the "consulting fees" were compensation for the Founding Shareholders' accounting and consulting services, but rather were nondeductible dividend distributions.

The court specifically rejected the firm's argument that since the consulting fees were allocated among the Founding Shareholders in proportion to the number of hours that each of them worked, rather than their stock ownership, those fees could not have been dividends. The court stated that whatever the method of allocation of the firm's income (in accordance with stock ownership or otherwise), if the fees were paid out of corporate income -- if every compensated hour included a capital return, the firm owed corporate income tax on the net income hiding in those fees and specifically stated that "a corporation cannot avoid tax by using a cockeyed method of distributing profits to its owners."[2]

The court went on to state that "remarkably, the firm's lawyers (*an accounting firm's lawyers*) appear not to understand the difference between compensation for services and compensation for capital …." The court also noted its puzzlement that the firm chose to organize as a conventional business corporation in the first place, and scathingly concluded by stating "That an *accounting firm* should so screw up its taxes is the most remarkable feature of the case."

As demonstrated by the *Mulcahy* case, it is very difficult, if not impossible, for most professional corporations to meet the independent investor test where the professional corporation distributes all or substantially all of its income in the form of compensation to its shareholder-employees (in which case the return for the independent

[2] See also, *Kennedy v. Comm'r*, 671 F.2d 167 (CA-6 1982), rev'g and remanding, 72 TC 793 (1979), where the court found that the fact that compensation payments are not made in proportion to the shareholder-employee's stock ownership does not preclude a finding that the compensation payment actually constituted a dividend.

investor would be 0%). The *Mulcahy* case represents yet another tool in the IRS's arsenal for attacking compensation paid to the shareholder-employees of a professional services corporation. In addition, the IRS has the ability to attack compensation paid to the shareholders of a professional services corporation based on the compensatory intent prong of Reg. 1.162-7(a), as demonstrated by *Richlands Medical Association,*[3] and *Pediatric Surgical Associates, P.C.*[4] Based upon the rate changes made by the American Taxpayer Relief Act of 2012, the highest marginal combined tax rate applicable to C corporation earnings distributed as dividends will be 48%. Additionally, note that such earnings are also subject to FICA (Social Security taxes), including the new 3.8% Medicare tax imposed on higher earning taxpayers. By taking into account the additional 3.8% Medicare tax, the maximum marginal rate on a "C" corporation's earnings distributed as dividends to its shareholders will be 50.47%.[5]

5. ***Thousand Oaks Residential Care Home I, Inc***. In *Thousand Oaks Residential Care Home I, Inc. v. Comm'r*, TCM 2013-10, the Tax Court, applying the five factor test set forth in the *Elliotts* case, as well as the independent investor test, disallowed a large portion of the compensation paid to the shareholders of a C corporation.

In *Thousand Oaks*, the taxpayers (Mr. and Mrs. Fletcher) owned and operated an assisted living facility for a number of years prior to selling the assisted living facility to a third party. Following the sale, the taxpayers continued to be employed at the assisted living facility by the new owner. For the years in issue, 2003, 2004 and 2005, the corporation paid Mr. Fletcher W-2 wages of $200,000, $200,000, and $30,000, respectively. Additionally, the corporation contributed $191,433 and $259,506 to a pension plan for the benefit of Mr. Fletcher in 2003 and 2004, respectively, for a total compensation package of $880,939. The corporation paid Mrs. Fletcher W-2 wages of $200,000, $200,000 and $30,000, for 2003, 2004 and 2005, respectively. Additionally, the corporation contributed $191,433 and $198,915 to a pension plan for the benefit of Mrs. Fletcher in 2003 and 2004, respectively, for a total compensation package of $820,348. The Board of Director minutes for the years in issue stated that the compensation to the taxpayers was approved for payment of back salaries that were not paid in prior years due to insufficient cash flow.

The IRS contended that the compensation packages paid to the taxpayers were not reasonable for the 2003, 2004 and 2005 tax years and disallowed

[3] TCM 1990-660.
[4] TCM 2001-81.
[5] See Looney and Levitt, "Operation of the Professional Corporation 2010: Reasonable Compensation Issues," for Professional and Other Service Businesses, proceedings of the New York University 69th Institute on Federal Taxation, May 2011.

the deductions for all of the compensation. The taxpayers, on the other hand, argued that the compensation paid in those years was reasonable and included "catch-up" payments for prior years in which they were under-compensated.

In its decision, the Tax Court did find that compensation for prior years services is deductible in the current year so long as the employee was actually undercompensated in prior years and the current payments are intended for past services. Additionally, the Tax Court stated that when the compensation was actually for prior years of service, it does not need to be reasonable in the year it is actually paid.

The Tax Court then went through an analysis of the five broad factors set forth in the *Elliotts* case. The Tax Court also specifically stated that in the Ninth Circuit, where an appeal in the taxpayers' case would lie, the independent investor test must also be taken into account. After analyzing the five factors set forth in the *Elliotts* case, the Tax Court then focused on the independent investor test. Citing a number of cases, the Tax Court found that a return on investment of between 10% and 20% tends to indicate compensation was reasonable. In particular, it stated that because the corporation in issue was a small highly leveraged business purchased with a large amount of debt, a hypothetical investor might be satisfied with a 10% return on his investment. Consequently, the Tax Court, taking into account a 10% rate of return, backed into the reasonable compensation to which the taxpayers were entitled, and disallowed a total of $282,615 of compensation paid to them.

III. EMPLOYMENT TAX ISSUES

A. THE SELF-EMPLOYMENT TAX

The self-employment tax ("SE Tax") can be a significant burden on taxpayers as it is imposed on net earnings from self-employment ("NESE") at the rate of 15.3% on the first $113,700 of such net earnings, and 2.9% on amounts in excess of $113,700. (Section 1402(a)). Excluded from the definition of NESE are certain capital gains, rental income, interest and dividends. Because individuals are entitled to an above the line deduction equal to one-half of the SE Tax paid under Section 164(f), the effective tax rate for the SE Tax is somewhat reduced. Among the factors to be considered in choosing the form of business entity that will be used to operate a closely-held business is the applicability of the SE tax on an owner's share of income from the business entity.

B. HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010

The Health Care and Education Reconciliation Act of 2010, H.R. 4872, P.L. 111-152, imposes a new Medicare tax on unearned income on partners, members of LLCs taxed as partnerships and S corporation shareholders. Specifically, Section

1411(a)(1) imposes a 3.8% Medicare tax on the lesser of (a) "net investment income" or (b) the excess of modified adjusted gross income over $250,000 in the case of taxpayers filing a joint return and over $200,000 for other taxpayers. Under Section 1411(c)(A)(i), "net investment income" includes gross income from interest, dividends, annuities, royalties, and rents other than such income which is derived in the ordinary course of a trade or business. Consequently, items of interest, dividends, annuities, royalties, and rents which pass through a partnership, LLC or S corporation to its partners, members or shareholders, will retain their character as net investment income and will be subject to the new 3.8% Medicare tax.

Additionally, the term "net investment income" includes: (1) any other gross income derived from a trade or business if such trade or business is a passive activity within the meaning of Section 469, with respect to the taxpayer; and (2) any net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business that is not a passive activity under Section 469 with respect to the taxpayer.

Consequently, not only does the new health care reform legislation subject investment income, for the first time ever, to the Medicare tax (rather than imposing the Medicare tax only on income derived from labor consistent with the policies underlying the Social Security tax), now a partner, ***including a limited partner***, LLC member and an S corporation shareholder, will be subject to the new 3.8% Medicare tax on his or her distributive share of the operating income of the partnership, LLC or S corporation, as the case may be, if the activity generating such income is passive under Section 469 with respect to such partner, LLC member or S corporation shareholder. It is disturbing to see the Medicare tax extended to investment income in general, and in particular to the operating income of S corporations, without a reasoned analysis of the effect that such a substantive change in the tax law will have on closely held businesses.

The Health Care and Education Reconciliation Act of 2010 also increased the Medicare portion of the self-employment tax by .9% (to 3.8%) on wages in excess of $250,000 in the case of taxpayers filing a joint return and more than $200,000 for other taxpayers.

The new Medicare tax provisions are effective for tax years beginning after January 31, 2012.

C. SOLE PROPRIETORSHIPS

Clearly, individuals earning income as sole proprietors (either as a sole proprietorship or a single member LLC which is treated as a disregarded entity under the Check-the-Box Regulations) from a trade or business are generally required to treat such ordinary income from that trade or business as NESE.

D. PARTNERSHIPS

The SE Tax treatment of general partners is generally understood: each general partner must include as NESE his distributive share of ordinary income (other than the excluded interest, rent and dividends). Section 1402(a)(13) excludes from NESE a limited partner's distributive share of partnership income (other than distributions that are guaranteed payments or compensation for services to the extent that those payments are established to be in the nature of remuneration for those services to the partnership). Accordingly, a general partner's distributive share of income from the partnership normally ***will be*** treated as NESE, while a limited partner's distributive share of income from the partnership normally ***will not be*** treated as NESE. The legislative history of Section 1402 makes clear that this exception for limited partners was intended to prevent passive investors, who do not perform services, from obtaining social security coverage or coverage under qualified retirement plans. One troubling issue relates to the application of the SE Tax with respect to a limited partner who also serves as a general partner in a partnership. Section 1402's legislative history reflects an intent to apply these rules separately to limited partnership and general partnership interests, even if held by the same partner. The lack of legislative or regulatory clarity has caused the application of rules for limited partners to be difficult.

E. LLCS TAXED AS PARTNERSHIPS

While multi-member LLCs (which do not elect to be treated as associations taxable as corporations) are treated as partnerships for tax purposes under the Check-the-Box Regulations, the SE Tax issues relating to LLCs and their members are at best unclear. The question to be addressed is whether members of such LLCs (taxed as partnerships) would be treated as limited partners under Section 1402(a)(13), so that their distributive share of LLC income and loss relating to their LLC interest is exempt from SE Tax.

On its face, the language of Section 1402(a)(13) would only exclude from NESE the distributive share of income ***of a limited partner*** of a partnership. Under such a literal reading, the distributive share of income of any other type or class of partner in the partnership would be considered NESE. Rev. Rul. 58-166, 1958-1 C.B. 224, held that the taxpayer's earnings from a working interest in an oil lease was NESE despite the fact that he had limited involvement in the organization.

1. **The 1994 Proposed Regulations**. With the advent of LLC statutes in the early 1990's and thereafter, the IRS attempted to address the SE Tax issue with respect to members of LLCs through the promulgation of Prop. Reg. §1.1402(a)-18 (the "1994 Regulations"). Under the 1994 Regulations, a member of a member-managed LLC would have been treated as a limited partner for purposes of Section 1402(a)(13) if: (i) the member was not a manager of the LLC; (ii) the LLC could have been formed as a limited partnership (rather than as an LLC in the same jurisdiction); and (iii) the

member could have qualified as a limited partner in that limited partnership under applicable law.

Accordingly, for manager-managed LLCs, whether a non-manager member's share of the LLC's income would be considered NESE turned on whether such member's interest could have been characterized as a limited partnership interest had the LLC been formed as a limited partnership. This factual determination often proved to be unworkable and depended on several factors, including the amount of the member's participation in the LLC's business operations and the provisions of the LLC Act and Limited Partnership Act of the applicable state.

2. **<u>The 1997 Proposed Regulations</u>**. The next attempt by the IRS to address the application of the SE Tax to members of an LLC were the 1997 proposed regulations. Prop. Reg. §1.1402-2(h) defines a "limited partner" for purposes of the SE Tax as an individual holding an interest in an entity classified as a federal tax partnership unless one of the following exceptions applies:

   a. The individual has personal liability for the debt of or claims against the partnership by reason of being a partner. For this purpose, an individual has personal liability if the creditor of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from such individual.

   b. The individual has authority under the law of the jurisdiction in which the partnership is formed to contract on behalf of the partnership.

   c. The individual participates in the partnership's trade or business for more than 500 hours during the partnership's tax year.

   Additionally, there are three exceptions to the general rule set forth in Prop. Treas. Reg. §1.1402-2(h), as follows:

   (1) Under the first exception, an individual who holds more than one class of interest in a partnership and who is not a limited partner under the general definition, may still be treated as a limited partner with respect to a specific class of interest. This exception is satisfied if immediately after the individual acquires the class of interest: (1) persons who are limited partners under the general definition own a substantial continuing interest in the class of interest; and (2) the individual's rights and obligations with respect to that class of interest are identical to the rights and obligations of the specific class held by the partners of that class who satisfy the general definition of a limited partner.

Whether the interests of the limited partners in the specific class under the general definition are substantial is determined based on all of the relevant facts and circumstances. There is a safe harbor under which 20% or greater ownership of the specific class is considered substantial. The proposed regulations define class of interest as an interest that grants the holder specific rights and obligations. A separate class exists if the holder's rights and obligations attributable to an interest are different from another holder's rights and obligations. The existence of a guaranteed payment to an individual for services rendered to the partnership is not a factor in determining the rights and obligations of a class of interest.

(2) The second exception applies to an individual who holds only one class of interest. Under this exception, an individual who cannot meet the general definition of limited partner because he or she participates in the partnership's trade or business for more than 500 hours during the partnership's tax year is treated as a limited partner if: (1) persons who are limited partners under the general definition own a substantial continuing interest in the class of interest; and (2) an individual's rights and obligations with respect to that class of interest are identical to the rights and obligations of that specific class held by persons who satisfy the general definition of a limited partner.

(3) The third exception applies to a service partner in a service partnership and provides that regardless of whether the individual can satisfy the general definition of a limited partner under one of the above-described exceptions, that individual may not be treated as a limited partner. A partnership is a service partnership if substantially all of its activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting. A service partner is a partner who provides services to or on behalf of the service partnership's trade or business unless that individual's services are de minimis.

3. **The Moratorium**. Immediately following the issuance of the 1997 regulations, significant protests were made. As a result of this significant protest, Congress enacted Section 935 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, which prohibited the issuance or effectiveness of temporary or final regulations with respect to the definition of a limited partner under Section 1402(a)(13) prior to July 1998. Although the

moratorium period has long since passed, no guidance on the definition of a limited partner for self-employment tax purposes under Section 1402(a)(13) has been issued to date.

Accordingly, as a result of the moratorium, there is a dearth of authority with respect to the SE Tax treatment of an LLC member's distributive share of an LLC's income. The only available guidance in existence are several private letter rulings that hold that a member is a partner and that a member's distributive share of partnership income is not excepted from NESE by Section 1402(a)(l3).[6]

While the Congress and the Treasury seem to have reached a deadlock on the self-employment tax issue involving partnerships, the American Bar Association Taxation Section and the AICPA Tax Division developed a legislative proposal to treat members of LLCs that are taxed as partnerships in the same manner as partners of partnerships generally. Simply put, under this proposal, income attributable to capital would be excluded from NESE and income attributable to services would be included. The effect of the proposal is to adopt two safe harbors for determining income attributable to capital, one on an interest-base return of capital, the other on an exclusion for amounts in excess of reasonable compensation for services rendered. This legislative proposal was submitted to Congressman Bill Archer by Paul Sachs on July 6, 1999.[7]

Interestingly, on June 10, 2003, Lucy Clark, a national tax issue specialist in the IRS's examination specialization program, stated that taxpayers may rely on the 1997 regulations. Specifically, she said that "if the taxpayer conforms to the latest set of proposed rules, we generally will not challenge what they do or don't do with regard to self-employment taxes."[8]

4. **The *Thompson* Case**. In *Thompson v. U.S.*, 87 F. Cl. 728 (2009), the United States Court of Federal Claims held that *an LLC member could not be treated the same as a limited partner* for purposes of meeting the material participation rules under the passive activity loss limitation rules of Section 469.

The taxpayer-member formed Mountain Air Charter, LLC ("Mountain Air") under the laws of the state of Texas. The taxpayer directly owned a 99% membership interest in Mountain Air and indirectly held the remaining 1% through an S corporation. Mountain Air's Articles of Organization designate the taxpayer-member as its only manager. Because Mountain Air did not elect to be treated as a corporation for

[6] See Ltr. Ruls. 9432018, 9452024 and 9525058.
[7] See Tax Notes, July 19, 1999, at 469.
[8] BNA's Daily Tax Report (Friday June 13, 2003), G-3.

federal income tax purposes, by default it was taxed as a partnership.[9] On his 2002 and 2003 individual income tax returns, the taxpayer-member claimed Mountain Air's losses of $1,225,869 and $939,870, respectively. The IRS disallowed the losses because it believed that the taxpayer did not materially participate in the business operations of Mountain Air.

Specifically, the IRS rested its conclusion on Reg. §1.469-5T, which sets forth the tests for what constitutes taxpayer material participation for purposes of applying the passive activity loss limitation rules of Section 469. The IRS found that Reg. §1.469-5T "explicitly treats interests in any entity which limits liability as limited partnership interests." Because the taxpayer enjoyed limited liability as a member of his limited liability company (Mountain Air), the IRS concluded that the taxpayer's interest was identical to a limited partnership interest. The taxpayer, on the other hand, argued that his membership interest should not be treated as a limited partnership interest for purposes of the passive activity loss limitation rules. The classification of a membership interest in an LLC as a "limited partnership interest" is important because a limited partner has fewer means by which he can demonstrate his material participation in the business. The parties specifically stipulated that if the taxpayer's membership interest is a limited partnership interest, then the taxpayer cannot demonstrate his material participation in the LLC and Section 469 will limit his losses. Likewise, the parties also stipulated that if the taxpayer's membership interest is ***not*** a limited partnership interest, then the taxpayer can demonstrate his material participation in the LLC and Section 469 does ***not*** limit his losses.

The taxpayer simply argued that his interest should not be treated as a limited partnership interest because Mountain Air was ***not*** a limited partnership. The IRS, on the other hand, argued that it was proper to treat the taxpayer's interest in Mountain Air as a limited partnership interest because the taxpayer elected to have Mountain Air taxed as a partnership for federal income tax purposes and the taxpayer's liability was limited under the laws of the state in which it was organized (Texas).

Based on the plain language of both the statute and the regulations, the court concluded that in order for an interest to be classified as a limited partnership interest the ownership interest must be in an entity that is, in fact, a partnership under state law and not merely taxed as such under the Code. Specifically, the court stated that once Reg. §1.469-5T(e)(3) is read in context and with due regard to its text, structure, and purpose, it becomes abundantly clear that it is simply inapplicable to a membership interest in an LLC.

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[9] Reg. §301.7701-3(b)(1)(i).

Furthermore, the court found that even if Reg. §1.469-5T(e)(3) could apply to the taxpayer and the court had to categorize his membership interest as either a limited or general partnership interest, it would best be categorized as a general partner's interest under Reg. §1.469-5T(e)(3)(ii) since a member in an LLC can actively participate in the management of the LLC (unlike limited partners of a limited partnership).

5. **<u>IRS Action on Decision</u>**. In Action on Decision 2010-14, IRB 515 (April 5, 2010), the IRS announced its acquiescence in result only in *Thompson*. In addition to *Thompson*, *Garnett v. Comm'r,* 132 TC 19 (2009), *Gregg v. U.S.*, 186 F.Supp.2d 1123 (D. Or. 2000), and *Newell v. Comm'r*, TCM 2010-23, have all ruled against the IRS's position that an interest in an LLC is a limited partnership interest under Reg. §1.469-5T(e)(3)(i).

According to Diana Miosi, special counsel in the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), the AOD was issued "to get the word out that we're not going to be litigating these cases anymore." Ms. Miosi's remarks were made on March 10, 2010 at a BNA Tax Management luncheon. Additionally, Miosi stated that the string of litigation losses has "gotten our attention," and that "it is important to try to get some guidance out in this area." Finally, Miosi noted that the government has struggled with the issue, not only with respect to Section 469, but also in other areas of the Code as well, such as Sections 464 and 736, and the self-employment tax area.

The distinction between membership interests in limited liability companies and limited partnership interests in limited partnerships will be of even greater significance because the new Medicare tax imposed on a partner's distributive share of the operating income of a partnership if the activity of the partnership producing the income is passive with respect to the partner under the passive activity loss limitation rules of IRC Section 469.

6. **<u>Implication of *Thompson* Case on Self-Employment Tax to LLC Members</u>**. The issue of whether the members of a multi-member LLC which is taxed as a partnership for federal income tax purposes are treated as general partners or limited partners for purposes of the self-employment tax is unclear at best. Obviously, the IRS could use the same reasoning used against the IRS in the *Thompson, Garnett*, *Newell* and *Gregg* cases to reach the conclusion that a member's interest in the LLC is *not* equivalent to a limited partner's interest in a limited partnership for purposes of self-employment tax. This would result in members of an LLC being subject to the self-employment tax on their distributive share of the income of an LLC (with certain exceptions for interest, dividends, rent and capital gain). However, on January 14, 2010, Diana Miosi reassured practitioners that they may rely on the proposed 1997 regulations in dealing with the

application of the self-employment tax to limited liability companies. See TNT, Jan. 15, 2010.

7. **<u>The *Robucci* Case</u>**. In *Robucci v. Comm'r*, TCM 2011-19, the Tax Court applied the two-pronged Moline Properties (*Moline Properties v. Comm'r*, 319 U.S. 436, 30 AFTR 1291 (1943)) test to disregard two corporations created by a psychiatrist (on the advice of his accountant) for the purpose of reducing his tax liabilities. The court also imposed an accuracy-related penalty under Section 6662(a) for a substantial understatement of income tax.

The taxpayer met with his advisor to explore the benefits of incorporating his practice, including minimizing taxes. The taxpayer's advisor, who was an attorney and certified public accountant (CPA), had an accounting practice that specialized in small businesses. "Choice of entity planning" for those businesses was a significant part of the advisor's practice.

The taxpayer's advisor recommended an organizational structure designed to transform the taxpayer's sole proprietorship into a limited liability company (LLC) classified as a partnership for federal income tax purposes with the intent of reducing self-employment tax. In particular, the LLC would have two members: the taxpayer, who would have a 95% interest, and a newly incorporated personal corporation ("Robucci P.C."), which was designated the manager of the LLC with a 5% interest. The taxpayer's 95% interest was split between an 85% interest as a limited partner and a 10% interest as a general partner. The case does not explain how the LLC could have partners classified as "general partners" and "limited partners." It is unclear why the advisor didn't use a single limited partnership as the choice of entity for the taxpayer. The 85% limited partner interest allegedly represented goodwill, the value of which was determined by the taxpayer's advisor but unsupported by any documentation. A second corporation ("Westphere") was formed for the purpose of providing services in connection with the taxpayer's practice, including its management and tracking its expenses and to creating a group eligible for medical insurance. Westphere charged the LLC "management fees" for its alleged services.

The taxpayer's advisor provided no written explanation of the reason for creating three entities and he never discussed with the taxpayer the basis for the 85%/10% split between his "limited" and "general" partnership interests. The taxpayer did not seek a second opinion from any other CPA or attorney assessing the merits of his advisor's recommendations. There was no valuation in support of the 85% limited partnership interest issued for intangibles, nor was there a written assignment of the tangible or intangible assets of the taxpayer's medical practice to the LLC.

The taxpayer paid self-employment tax only on net income allocated to him as general partner (i.e., 10% of LLC's net income), whereas, as a sole proprietor, he was required to pay self-employment tax on the entire net income from his psychiatric practice. See Sections 1401 and 1402.

The court analyzed the facts under the two-prong test of *Moline Properties*. Under this test, a corporation is recognized as a separate legal entity if either:

(1) The purpose of its formation is the equivalent of business activity.

(2) The incorporation is followed by the carrying on of a business by the corporation.

Under the first prong, the court found that both Robucci P.C. and Westphere were formed solely to reduce the taxpayer's tax liability and not with a business purpose (i.e., there was no equivalent of business activity on corporate formation). With respect to Westphere, the court concluded that its only activity was the equivalent of "taking money from one pocket and putting it into another." Under the second prong of the *Moline Properties* test, the court found that both Robucci P.C. and Westphere "were, essentially, hollow corporate shells," which lead to the conclusion that "neither carried on a business after incorporation." Thus, the court disregarded both corporations.

Because Robucci P.C. was disregarded for tax purposes, the court found that the LLC had only one owner, the taxpayer. Because no election was made to classify the LLC as a corporation, the LLC was disregarded and its owner was treated as a sole proprietor. Consequently, the taxpayer was treated as a sole proprietor for federal tax purposes, which was his status before formation of the three entities. See Reg. §§ 301.7701-1 through -3.

8. **The *Renkemeyer* Case**. In *Renkemeyer, Campbell & Weaver, LLP v. Comm'r*, 136 TC 137 (2011), the Tax Court disallowed a law firm's special allocation of business income and held that the firm's attorney partners were liable for self-employment tax on allocations of partnership income related to the law firm's legal practice.

Renkemeyer, Campbell & Weaver, LLP is a Kansas law firm. During the 2004 tax year, the firm's partners included three attorneys and RCGW Investment Management, Inc., a subchapter S corporation that was wholly owned by an Employee Stock Ownership Plan and Trust (the "ESOP") benefiting the three attorneys. The law firm timely filed its partnership tax return for the 2004 tax year, which allocated 87.557% of the law firm's net income to the ESOP. The IRS issued an FPAA for tax years 2000, 2001, and 2002 to the law firm, which:

(1) Disallowed the special allocation to the ESOP and determined that net business income should be reallocated to the partners consistent with the profit and loss sharing percentages reported on the partners' respective Schedules K-1.

(2) Determined that the partners' distributive shares of the law firm's net business income were subject to self-employment tax.

Although the law firm asserted that the special allocation to the ESOP was proper under the partnership agreement, it could not produce a copy of the partnership agreement for the record. Therefore, the court looked to the partners' respective interests in the partnership to determine whether the special allocation had economic reality. Based on an analysis of relative capital contributions, distribution rights, and profit and loss sharing percentages, the court concluded that the special allocation of the law firm's net business income for the 2004 tax year was improper and should be disallowed.

Section 1402(a) provides several exclusions from the general self-employment tax rule, including an exclusion under Section 1402(a)(13) for the distributive share of any item of income or loss of a limited partner (other than guaranteed payments in the nature of remuneration for services). Because the term "limited partner" is not defined in the statute, the court had to determine whether an attorney partner who provides services in a law firm structured as a limited liability partnership can be treated as a "limited partner" for purposes of the exclusion under Section 1402(a)(13).

The court examined the statute's legislative history, which revealed that the intent of Section 1402(a)(13) was to ensure that individuals who merely invest in a partnership and do not actively participate in the partnership's business operations (which was the archetype of limited partners at the time) do not receive credits toward Social Security coverage. The court determined that the legislative history did not contemplate excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons) from liability for self-employment taxes. Because nearly all of the law firm's revenues were derived from legal services performed by the attorney partners in their capacities as partners, the court determined that the partners' distributive shares of the law firm's income did not arise as a return on the partners' investment and were not "earnings which are basically of an investment nature." Therefore, the court held that the attorney partners' distributive shares arising from legal services they performed on behalf of the law firm were subject to self-employment taxes. Because the law firm was formed as a limited liability partnership rather than a limited partnership, it did not actually have “limited” or “general” partners as would a limited partnership.

9. **The *Howell* Case**. In *Howell v. Comm'r,* TCM 2012-303. the Tax Court held a couple liable for self-employment tax under Section 1401 on payments made to the wife by their LLC, finding that the couple could not disavow the reporting position they took on the company's returns by later arguing the payments were partnership distributions rather than guaranteed payments.

In *Howell*, the taxpayers, husband and wife, formed a California limited liability company to provide software and hardware to hospitals consisting of a remote access system that enabled doctors to access hospital records from outside the hospital. When the LLC was first organized, Mr. Howell decided to make Mrs. Howell a member of the LLC rather than himself for various reasons. On the LLC's tax returns, the LLC treated the amounts in issue as guaranteed payments to Mrs. Howell. The taxpayers later argued that these guaranteed payments actually represented distributions from the LLC to Mrs. Howell on which no self-employment tax was owed.

Under Section 1402(a), the term “self-employment income” generally includes an individual's distributive share of income or loss from a trade or business carried on by a partnership of which the individual is a member. While a partner generally must include his distributive share of income in his net earnings from self-employment, Section 1402(a)(13) provides that in certain circumstances, a limited partner may exclude his distributive share of income from net earnings from self-employment. Specifically, Section 1402(a)(13) excludes from the definition of net earnings from self-employment a limited partner's distributive share of partnership income, other than distributions that are guaranteed payments or compensation for services to the extent those payments are established to be in the nature of remuneration for those services.

While multi-member LLCs (which do not elect to be treated as associations taxable as corporations) are treated as partnerships for tax purposes under the check-the-box regulations, application of the self-employment tax to LLC members is at best unclear. The specific question is whether members of such LLCs (taxed as partnerships) should be treated as limited partners under Section 1402(a)(13), so that their distributive share of LLC income and loss is exempt from the self-employment tax, or whether they should be treated as general partners so that their distributive share of LLC income and loss is subject to the self-employment tax.[10]

In its decision, the Tax Court cited its earlier decision in *Renkemeyer*, for the proposition that the legislative history of Section 1402(a)(13) does not contemplate excluding partners who perform services for a partnership in their capacity as partners from liability for self-employment taxes, and that the Section 1402(a)(13) exemption was only meant to exclude from self-employment income the distributive share of individuals who merely invested in the partnership and who were not actively participating in the partnership's business operations, and whose distributive shares were earnings "basically of an investment nature." Specifically, the court in *Renkemeyer* held that the taxpayers were not limited partners for purposes of Section 1402(a)(13) because the distributive shares received arose from legal services performed on behalf of the law firm by the taxpayers and did not arise as a return on the taxpayers' investment in the law firm.

The Tax Court first found that even if they allowed the taxpayers to disavow the form of the transaction adopted on the LLCs returns (i.e., as guaranteed payments), the taxpayers must offer strong proof to show that the reporting was incorrect, which the taxpayers failed to do.

Additionally, based on the *Renkemeyer* case, the court found that Mrs. Howell performed services for the LLC and was not merely a passive investor, and as such, could not be treated as a limited partner under Section 1402(a)(13).

<u>Observation</u>. The *Howell* case, as well as the Tax Court's prior decision in *Renkemeyer*, indicate that it will be difficult for an LLC member to be treated as "limited partner" under Section 1402(a)(13) for purposes of excluding his or her distributive share of the income of the LLC from the self-employment tax any time such member provides services to or on behalf of the LLC and who is characterized other than as a passive investor of the LLC. This should be contrasted with a shareholder of an S corporation who materially participates in the business, where only amounts paid as reasonable salary should be subject to Social Security taxes on such wages, and the shareholder's distributive share of the income of the S corporation and all dividend distributions should be exempt from the self-employment tax and Social Security taxes by reason of Rev. Rul. 59-221[11] and Section 1402(a)(2). An S corporation shareholder who materially participates in an active trade or business carried on by an S corporation should also not be subject to the new tax

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[10] The treatment of LLC members for self-employment tax purposes has been an issue the IRS has struggled with for many years. See e.g., Prop. Reg. 1.1402(a)(18) (issued in 1994 and later withdrawn); and Prop. Reg. 1.1402-2(h) (issued in 1997 but never finalized).

[11] 1959-1, CB 225.

imposed on net investment income with respect to such shareholder's distributive share of the S corporation's income by virtue of Section 1411(c)(2)(A).[12]

F. S CORPORATIONS

Because the Federal Insurance Contributions Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes may be substantial, many shareholder-employees of S corporations have employed a strategy of decreasing the amount of wages that they receive from the S corporation and correspondingly increasing the amount of S corporation distributions made to them.

1. **Social Security Taxes on Wages**. As part of FICA, a tax is imposed on employees and employers up to a prescribed maximum amount of employee wages. This tax is comprised of two parts, the Old-Age, Survivor, and Disability Insurance (OASDI) portion and the Medicare Hospital Insurance (HI) portion. The HI tax rate is 1.45% on both the employer and the employee, and the OASDI tax rate is 6.2% on both the employer and the employee. The maximum wages subject to the OASDI tax rate for 2013 is $113,700.

   RRA '93 repealed the dollar limit on wages and self-employment income subject to the HI portion of the FICA tax as well as the self-employment tax. Thus, employers and employees will equally be subject to the 1.45% HI tax on *all* wages, and self-employed individuals will be subject to the 2.9% HI tax on *all* self-employment income.

   As discussed above, beginning in 2013, the HI portion of the Social Security tax will be increased from 2.9% (combined employer and employee) to 3.8% (combined employer and employee) for wages in excess of $250,000 for married individuals filing jointly and in excess of $200,000 for other taxpayers. Additionally, as discussed above, beginning in 2013, a taxpayer having modified adjusted gross income in excess of $250,000 in the case of married individuals filing jointly and $200,000 for other taxpayers will be subject to the 3.8% Medicare tax on their net investment income.

2. **Social Security Taxes and S Corporations**. In order for shareholder-employees of S corporations to realize employment tax savings by withdrawing funds in the form of distributions rather than compensation, such distributions must not be recharacterized as "wages" for FICA purposes or as NESE for purposes of the SE Tax. For FICA and FUTA purposes, Sections 3121(a) and 3306(b), respectively, define the term

[12] The Health Care and Education Reconciliation Act of 2010, H.R. 4872, P.L. 111-152, imposes a 3.8% Medicare tax on the lesser of (a) net investment income or (b) the excess of modified adjusted gross income over $250,000 in the case of taxpayers filing a joint return and over $200,000 for other taxpayers. The definition of net investment income is quite expansive for purposes of the new 3.8% Medicare tax imposed under Section 1411(a)(1).

"wages" to mean all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions.

Although it might appear at first glance that a shareholder's distributive share of income from an S corporation constitutes NESE since a general partner's distributive share of the income of any trade or business carried on by a partnership of which he is a member generally constitutes NESE subject to the SE Tax, in Rev. Rul. 59-221, 1959-1 C.B. 225, the IRS found that an S corporation's income does not constitute NESE for purposes of the SE Tax. Additionally, Section 1402(a)(2) specifically excludes from the definition of NESE dividends on shares of stock issued by a corporation.

Consequently, neither a shareholder's distributive share of income passed through from the S corporation under Section 1366 nor any S corporation distributions actually received by the shareholder from the S corporation constitute NESE subject to the SE Tax. In Rev. Rul. 66-327, 1966-2 C.B. 357, the IRS found that the taxable income of an S corporation included in its shareholders' gross income is not income derived from a trade or business for purposes of computing the shareholders' net operating losses under Section 172(c). Similarly in Ltr. Rul. 8716060, the IRS concluded that the income derived by a shareholder-employee from an S corporation did not constitute net earnings from self-employment for self-employment tax purposes and that such taxpayer was not eligible to adopt a qualified pension plan based on the income derived from his S corporation since such income did not constitute earned income.

Because wages paid to shareholder-employees of S corporations are subject to Social Security taxes while S corporation distributions are not, shareholder-employees have an opportunity for significant tax savings by withdrawing funds from the S corporation in the form of distributions rather than wages. Prior to advising an S corporation with shareholder-employees to undertake such a tax planning strategy, however, the tax practitioner should analyze the economic and tax consequences that such a strategy will have on the S corporation and its shareholders. [13]

Although the amount of funds available for distribution to an S corporation's shareholder-employees will increase as the wages paid to them decrease, all distributions made by the S corporation to its shareholders must be made in proportion to the number of shares held by

[13] See generally, Looney & Levitt, Reasonable Compensation Issues for Closely-held and Service Companies," 61st N.Y.U. Ann. Inst. Fed. Tax'n 16 (2003); Looney & Comiter, "Reasonable Compensation: Dividends vs. Wages - A Reverse in Positions," 7 J. Partnership Tax'n 364 (Winter 1991); Clements & Streer, "How Low Can Owner-Employee Compensation be Set to Save on Employment Taxes?" 2 J. S. Corp. Tax'n 37 (1990); Andrews, "Current Non-Stock Executive Compensation and Fringe Benefit Issues," 1 S Corp.: J. Tax, Leg. & Bus. Strategies 3 (1989); and Spradling, "Are S Corp. Distributions Wages Subject to Withholding?" 71 J. Tax'n 104 (1989).

such shareholders under Section 1361(b)(1)(D). Thus, if an S corporation which has both shareholders who are employees and shareholders who are not employees adopts a tax strategy to reduce Social Security taxes by minimizing wages and maximizing distributions, the increase in the amount of distributions received by the shareholders who are employees will be less than the amount by which their wages were reduced (since distributions must also be made to the shareholders who are not employees). Additionally, a program that minimizes the amount of wages paid to shareholder-employees will increase: (1) purchase price formulas based on earnings; and (2) bonus formulas based on earnings. Decreasing the amount of wages paid to shareholder-employees of S corporations also will reduce the contribution base for contributions to the corporation's qualified plans.

3. **<u>S Corporations and Unreasonably Low Compensation - Reclassification Risks</u>.**

a. In Rev. Rul. 74-44, 1974-1 C.B. 287, two shareholders of an S corporation withdrew ***no salary*** from the corporation and arranged for the corporation to pay them dividends equal to the amount that they would have otherwise received as reasonable compensation for services performed. This arrangement was made for the express purpose of avoiding payment of federal employment taxes. Based on the expansive definition of wages for FICA and Federal Unemployment Tax Act ("FUTA") purposes (which includes all remuneration for employment), the IRS found that the dividends paid to the shareholders constituted wages for FICA and FUTA purposes. Rev. Rul. 74-44 did not, however, address the issue of what constitutes reasonable compensation in the S corporation context since the ruling expressly stated that the dividends were received by the shareholder-employees in lieu of the reasonable compensation that would have otherwise been paid to them. Despite this shortcoming, Rev. Rul. 74-44 clearly indicates that the payment of ***no*** compensation will be unreasonable where shareholder-employees provide substantial services to the corporation.[14]

b. In *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990), the court recharacterized distributions made to the sole shareholder (an attorney) of an S corporation (a law firm) as wages subject to FICA and FUTA taxes, where the shareholder made all of his

[14] See also Rev. Rul. 71-86, 1971-1 C.B. 285 (president and sole shareholder of closely-held corporation found to be an "employee" of the corporation for employment tax purposes); Rev. Rul. 73-361, 1973-2 C.B. 331 (officer-shareholder of an S corporation who performed substantial services as an officer of the S corporation is an "employee" of the corporation for purposes of FICA, FUTA and income tax withholding); and Ltr. Rul. 7949022 (shareholder-employees of S corporation who perform substantial services for S corporation treated as "employees" for employment tax purposes).

withdrawals from the S corporation in the form of S corporation distributions and received ***no salary*** from the S corporation during the tax year. The court relied on a broad definition of wages for FICA and FUTA purposes as all remuneration for employment, and concluded that the dividend payments were remuneration for services performed by the shareholder for the S corporation. Likewise, in *Spicer Accounting, Incorporated v. U.S.,* 918 F.2d 80 (9th Cir. 1990), the court recharacterized dividend distributions made to a shareholder (an accountant) of an S corporation (an accounting firm) as wages subject to FICA and FUTA taxes where the shareholder received ***no salary*** during the tax year.

c. Additionally, in *Fred R. Esser, P.C. v. U.S.,* 750 F. Supp. 421 (D. Ariz. 1990), the court recharacterized amounts received by the sole shareholder, officer and director of a legal services S corporation, as wages subject to FICA and FUTA taxes, rather than as distributions. As in the *Radtke* and *Spicer Accounting* cases, the shareholder received ***no salary*** from the S corporation during the tax year.

d. In *Donald G. Cave, A Professional Law Corp. v. Comm'r*, 109 AFTR2d 91 2012-609 (5th Cir. 2012), *aff'g per curiam*, TCM 2011-48, the court held that all of the non-shareholder attorneys, as well as a law clerk, of a law firm were common law employees rather than independent contractors, and also recharacterized the distributions made to the sole shareholder of the law firm, who was determined to be a statutory employee, as wages subject to Social Security taxes.

e. In *David E. Watson P.C. v. U.S.*, 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010), the Eighth Circuit Court of Appeals affirmed the decision of the district court recharacterizing a significant portion of dividend distributions made by an S corporation to its sole shareholder as wages subject to Social Security taxes.

During the years in issue, 2002 and 2003, David E. Watson, CPA ("Watson"), provided accounting services to a partnership ("LWBJ") and its clients as an employee of David E. Watson P.C., an S corporation (the "S Corporation"). The S Corporation was a 25% partner in LWBJ. The IRS made assessments against Watson after it determined that portions of the dividend distributions from the S Corporation to Watson should be recharacterized as wages subject to employment taxes. Specifically, the IRS contended that \$130,730.05 out of a total of \$203,651 of dividend payments to Watson for 2002 should be recharacterized as wages subject to employment taxes, and that \$175,470 out of a total of \$203,651 of dividend payments to Watson for 2003 should be recharacterized as wages subject to employment taxes. In both years, Watson received a salary of $24,000 in addition to the dividend distributions.

In his Motion for Summary Judgment, Watson argued that the intent of the S Corporation was controlling in determining the characterization of the payments from the S Corporation to Watson. Because the S Corporation clearly intended to pay Watson compensation of only $24,000 per year, Watson contended that any amounts distributed in excess of the $24,000 were properly classified as dividends. In support of his position, Watson cited *Electric & Neon, Inc. v. Comm'r*, 56 TC 1324 (1971); *Paula Construction Co. v. Comm'r,* 58 TC 1055 (1972), and *Pediatric Surgical Associates, P.C. v. Comm'r,* TCM 2001-81.

Citing Rev. Rul. 74-44, 1974-1 CB 287, *Radtke, Spicer Accounting* and *Veterinary Surgical Consultants*, the district court found that the intent of the S Corporation was not controlling in determining the character of the payments, but rather that the analysis turns on whether the payments at issue were made as remuneration for services performed. Consequently, the court denied Watson's Motion for Summary Judgment because it found that there was a genuine issue of material fact as to whether the dividends paid to Watson by the S Corporation were remuneration for services performed subject to employment taxes.

After denying the taxpayer's Motion for Summary Judgment, the district court held a bench trial on the merits. At trial, the government's expert opined that the market value of Watson's accounting services was approximately $91,044 per year for 2002 and 2003. The government's expert was a general engineer with the IRS and had worked on approximately 20 to 30 cases involving reasonable compensation issues. In forming his opinion as to Watson's salary, the government's expert relied on several compensation surveys and studies particularly relating to accountants. The district court ultimately adopted the government expert witness's opinion and determined that the reasonable amount of Watson's remuneration for services performed totaled $91,044 for each of 2002 and 2003.

In addition to determining the issues of what constituted reasonable compensation to the sole shareholder of the S corporation and whether intent was the determinative factor in determining whether payments from an S corporation to its sole shareholder should be characterized as wages or as dividend distributions, the court first addressed the taxpayer's argument that the district court erred in allowing the government's expert to testify on the issue of reasonable compensation because he was not competent to testify on that issue. Specifically, the taxpayer asserted that the government's expert witness was not qualified, changed his opinion, relied on insufficient underlying facts, and used flawed methods in rendering his opinion. After reviewing all of these factors in detail, the court of appeals determined that the district court did not abuse its discretion in admitting the testimony of the government's expert witness, and found the taxpayer's arguments meritless.

In reaching its decision, the Eighth Circuit cited Rev. Rul. 74-44, *Radtke*, *Spicer Accounting* and *Veterinary Surgical Consultants* cases (discussed above), and concluded that the district court properly determined that the characterization of funds disbursed by an S corporation to its shareholders turns on an analysis of whether the payments at issue were made as remuneration for services performed. The court went on to state that the district court found that the S corporation understated wage payments to its sole shareholder by $67,044 in each year based on a variety of factors. These factors included the following evidence: (1) Watson was an exceedingly qualified accountant with an advanced degree and nearly 20 years in accounting and taxation; (2) Watson worked 35-45 hours per week as one of the primary earners in a reputable firm, which had earnings much greater than comparable firms; (3) the partnership had gross earnings of over $2M in 2002 and nearly $3M in 2003; (4) $24,000 is unreasonably low compared to other similarly situated accountants; (5) given the financial position of the partnership, Watson's experience and his contributions to the partnership, a $24,000 salary was exceedingly low when compared to the roughly $200,000 the partnership distributed to Watson's S corporation in 2002 and 2003; and (6) the fair market value of Watson's services was $91,034.

The Eighth Circuit next addressed the taxpayer's argument that instead of focusing on reasonableness, the district court should have focused on the S corporation's intent. While acknowledging that § 162(a)(1) provides that the deductibility of compensation is a two prong test in that the compensation must both be reasonable in amount and in fact payments purely for services, the court, citing *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241, 83-2 USTC ¶9610 (9th Cir. 1983), *rev'g* TCM 1980-282, stated that courts usually only need to examine the first prong since the reasonableness prong generally subsumes the inquiry into compensatory intent in most cases. The court did state however, that in certain rare cases whether there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness.

In the case, the taxpayer cited *Pediatric Surgical Associates* in support of his position that taxpayer intent controls in FICA tax characterization cases. The Eighth Circuit found that even if intent does control, after evaluating all the evidence, the district court specifically found that the shareholder's assertion that the S corporation intended to pay him a salary of only $24,000 a year to be less than credible. Additionally, the Eighth Circuit Court of Appeals went on to reject the argument made by the taxpayer that *Pediatric Surgical Associates* limited the amount that could be characterized as wages to the amount of revenue each shareholder-employee personally generated less expenses since, like *Pediatric Surgical Associates*, nonshareholder-employees also contributed to the S corporation's earnings. The Eighth Circuit Court of Appeals brushed this argument aside by saying that although they thought evidence of shareholder-employee billings and collections may be probative on the issue of compensation, in light of all the evidence presented to the district court in the case, they saw no error and affirmed the decision of the district court.

<u>*Observation*</u>. The *Watson* case is the first reported decision in which the court was presented with a situation which was not clearly abusive such as those presented in *Radtke* and *Spicer Accounting* (i.e., where all of the earnings of the S corporations were paid to the sole shareholder as dividend distributions and no salary was paid to the shareholder by the S corporation). Consequently, the Watson decision represents an important victory for the IRS in being able to recharacterize dividend distributions as wages where at least some (but less than a reasonable) salary has been paid to the shareholder-employees of the S corporation. Additionally, however, the *Watson* case is somewhat troubling in its rejection of the decision reached in the *Pediatric Surgical Associates* case (in which the IRS sought to recharacterize wages of a C corporation as dividend distributions rather than vice versa), in that the court did not seem to take into account the fact that dividend distributions can indeed be generated by the services of nonshareholder-employees of an S corporation or from other ancillary services not provided by the shareholder-employees of the S corporation.

f. *In Herbert v. Comm'r,* TC Summ. Op. 2012-124, the Tax Court recharacterized a portion of the amounts the taxpayer claimed were used to pay business expenses as wages subject to Social Security taxes, finding the taxpayer's salary was unreasonably low. However, the Tax Court expressly rejected the IRS's contention that the taxpayer's salary be increased by $52,600, primarily based on the salary paid by the S corporation to the shareholder in a prior year in which the business was not owned by the taxpayer.

In reaching this decision, the Tax Court believed and accepted the taxpayer's testimony that the taxpayer in fact paid significant expenses of the corporation with cash funds received from the corporation. Additionally, the court found that in spite of limited evidence before them, they believed that it was improper and excessive to charge the taxpayer with receipt from the corporation in 2007 of $52,600 in additional wages. On the other hand, the court stated that the taxpayer's reported wages of $2,400 was unreasonably low.

Consequently, citing *Mason Manufacturing Co. v. Comm'r*, 178 F.2d 115 (6th Cir. 1949), the Tax Court averaged the taxpayer's wages for 2002 through 2006, and used the average amount as the total for the taxpayer's 2007 wages subject to employment taxes ($30,445).

The *Herbert* case and the *Watson* case discussed above involve situations where only a portion of amounts not treated as wages are recharacterized as wages subject to Social Security taxes, and each involves different methods in determining what constitutes "reasonable compensation" to the shareholder-employees of an S corporation.

g. The *Radtke*, *Spicer Accounting* and *Esser* cases indicate that in abusive situations, such as where the shareholders of an S corporation make all withdrawals from the S corporation in the form of S corporation distributions and ***receive no salary from the*** *S* corporation ***during the*** **tax year,** ***the courts*** will recharacterize such distributions as wages subject to Social Security taxes. These earlier cases have been followed in more recent cases. See *Veterinary Surgical Consultants, P.C. v. Comm'r*, 117 TC 14 (2001), *Van Camp and Brennion v. U.S.*, 251 F.3d 862 (9th Cir. 2001), *Old Raleigh Realty Corp. v. Comm'r.*, TC Summ. Op. 2002-61, *David E. Watson P.C. v. U.S.*, 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010), and *Herbert v. Comm'r*, TC Summ. Op. 2012-124.

h. In non-abusive situations, however, the IRS may have difficulty in successfully asserting that distributions made by S corporations to shareholder-employees should be recharacterized as wages subject to Social Security taxes. In order for the IRS to recharacterize S corporation distributions as wages subject to Social Security taxes in non-abusive situations, the IRS would have to overcome: (i) the lack of express authority for its position (unlike the express authority granted to the IRS under Section 1366(e) to recharacterize dividend distributions as wages in the family context); (ii) the burden of overcoming the initial characterization of the payment as a distribution; and (iii) the uncertainty surrounding the utilization of Section 162(a)(1) by the IRS in the employment context to bring salaries ***up*** to a reasonable level.

i. Consequently, in such situations, a tax strategy of decreasing wages and correspondingly increasing distributions to shareholder-employees could result in substantial employment tax savings**.** As a result of this tax planning technique, the IRS, the Joint Committee on Taxation and the Department of Treasury have issued reports and notices addressing the use of S corporations as a means of avoiding the SE Tax.

G. RECENT ATTEMPTS TO SUBJECT S CORPORATIONS TO THE SELF-EMPLOYMENT TAX

There have been numerous attempts in recent years to subject S corporation earnings to the self-employment tax.

1. In 2002, the Treasury Inspector General for Tax Administration issued a report entitled “The Internal Revenue Service Does Not Always Address Subchapter S Corporation Officer Compensation During Examinations,” (Reference No. 2002-30-125 (July 5, 2002)), where it was found that IRS examiners failed to address officer compensation issues in 13 out of 58 cases reviewed, and it was recommended that additional technical guidance be given to field personnel in determining reasonable officer compensation.

2. On April 5, 2004, the IRS issued a news release, I.R. 2004-47, identifying several types of “schemes” to avoid the payment of employment taxes that have resulted in adverse court rulings or convictions of taxpayers. Among the schemes listed is “S corporation officers’ compensation treated as corporate distributions”, which it describes as follows: “In an effort to avoid employment taxes, some corporations are improperly treating officer compensation as a corporate distribution instead of wages or salary. By law, officers are employees of the corporation for employment tax purposes and compensation they have received for their services is subject to employment taxes.”

3. In January, 2005, the staff of the Joint Committee on Taxation (“JCT”) released a report titled “Options to Improve Tax Compliance and Reform Tax Expenditures.” This report proposed that S corporations be treated as partnerships and any shareholders of S corporations be treated as general partners. As a result, the shareholders of the S corporation would be

subject to SE Tax on their shares of S corporation net income (whether or not distributed) in the same manner as partners. Under the JCT's proposal, with respect to service businesses, all shareholders' net income from the S corporation would be treated as NESE.

4. On May 25, 2005, J. Russell George, the Inspector General, Treasury, Inspector General, for Tax Administration testified before the Senate Finance Committee, complaining about the employment tax inequities that exist between sole-proprietorships and single-shareholder S corporations. Mr. George noted that the amount of potential employment tax collection lost in 2000 was 5.7 billion dollars based on a comparison of the profits of single-shareholder S corporations and the amounts shown by the single shareholder as compensation subject to employment tax. In connection with that testimony, Pamela Gardiner, Deputy Inspector General for Audit of the Inspector General for Tax Administration issued a final audit report entitled "Actions are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole-Proprietorships and Single-Shareholder S Corporations."

5. In July, 2005, the IRS announced its plan to conduct an intensive study of 5,000 randomly selected S corporations. The IRS reports that the study will be used to more accurately gauge the extent to which the income, deductions and credits from S corporations are properly reported on returns and will assist the IRS in selecting and auditing S corporation returns with greater compliance risks. While the notice did not specify that compliance with the SE Tax rules is a focus of the study, it is not difficult to imagine that the SE Tax was one of the issues that will be closely watched.

6. In conjunction with its 2005 report, the Senate Finance Committee released a report on October 19, 2006 entitled "Additional Options to Improve Tax Compliance" that was prepared by the members of the JCT. The report addressed, among other things, a proposal that would generally treat service partnerships, LLCs and S corporations the same for SE Tax purposes, so that a partner's, member's or shareholder's distributive share of income from a service entity would be subject to the SE Tax. The proposal sought to eliminate the "choice of business form" decision that results in substantially different tax liability for otherwise similar forms of business.

7. In reaction to this "controversial and politically charged" report, the Partnerships and LLCs Committee and the S Corporations Committee of the American Bar Association published their comments. These comments suggested, among other things, that the rules currently in effect for S corporations were correct and should *not* be changed.

8. Senator Rangel introduced a Bill in 2007 that would essentially subject all income from a service entity, whether a partnership, LLC or S corporation, to the SE Tax.

9. The Joint Committee on Taxation again addressed the SE Tax issue in JCT Report (JCX-48-08) on Selected Federal Tax Reform Issues Relating to Small Business, Choice of Entity for a June 5, 2008, Senate Finance Committee Hearing.

10. In IRS Fact Sheet FS-2008-25, the IRS clarified information that small business taxpayers should understand regarding the tax law for corporate officers who perform services for S corporations. In the Fact Sheet, the IRS points out that just because an officer is also a shareholder of the S corporation, it does not change the requirement that payments to the corporate officer must be treated as wages, and that courts have consistently held that S corporation officer-shareholders who provide more than minor services to the corporation and who receive or are entitled to receive payments are employees whose compensation is subject to federal employment taxes.

    The Fact Sheet goes on to discuss that although there are no "bright line" tests for determining what constitutes "reasonable compensation" to S corporation officer-shareholders, the following factors have been considered by the courts in determining reasonable compensation:

    a. Training and experience.

    b. Duties and responsibilities.

    c. Time and effort devoted to the business.

    d. Dividend history.

    e. Payments to non-shareholder employees.

    f. Timing and manner of paying bonuses to key people.

    g. What comparable business pay for similar services.

    h. Compensation agreements.

    i. The use of a formula to determine compensation.

11. Faris Fink, Commissioner of the Small Business and Self-Employed Division of the IRS, stated on October 29, 2008 that over the next 12 months the Small Business and Self-Employed Division of the IRS will focus on taxpayer services and increased enforcement, and that S corporations "will be a significant compliance challenge going forward,"

noting that the Small Business and Self-Employed Division must carry out a better examination of S corporations and how they are used.

12. On January 15, 2010, the United States Government Accountability Office ("GAO") released a report entitled "Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules" (the "Report") (December 15, 2009, GAO-10-195). The author participated in the GAO study as part of a group of individuals who are members of the S Corporations Committee of the American Bar Association ("ABA") Tax Section. This group of individuals also included the immediate past Chair of the S Corporations Committee, Tom Nichols. The participation of such persons in the study was *solely as individuals* and not as representatives of the S Corporations Committee or the ABA Tax Section.

The involvement of this group included participating in a preliminary telephone call with GAO representatives, the review of a list of "S corporation Interview Topics" prepared by the GAO, and a lengthy follow-up telephone conference with GAO representatives.

The purported purpose of the GAO study was to look at "compliance challenges" for S corporations and their shareholders. The genesis of the GAO study seems to be the report released on October 19, 2006 entitled "Additional Options to Improve Tax Compliance" that was prepared by members of the Joint Committee on Taxation. The purpose of this report was to find ways to close the "tax gap." Simply defined, the "tax gap" is the difference between the federal income tax that taxpayers should be paying if they fully complied with the federal tax laws ***currently in effect***, and the actual amount of federal income taxes being paid by taxpayers. The report addressed, among other things, a proposal that would generally treat service partnerships, LLCs and S corporations the same for self-employment tax purposes, so that a partner's, member's or shareholder's distributive share of income from a service entity would be subject to the self-employment tax. The proposal sought to eliminate the "choice of business form" decision that results in substantially different tax liability for otherwise similar forms of business.

In reaction to this controversial and politically charged report, the American Bar Association Tax Section issued comments which provided, among other things, that the rules currently in effect for S corporations were correct and should not be changed. Specifically, the report provided that the self-employment tax, as well as FICA and FUTA taxes, were meant to be imposed on income from labor and that the IRS has all the necessary "tools" in place to combat abusive situations where S corporations are not paying their shareholder-employees reasonable compensation. *See*, e.g., Rev. Rul. 74-44, 1974-1 C.B. 287, *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990), and *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 80 (9th Cir. 1990). Specifically, the ABA Tax Section stated the following:

> Such a wholesale expansion of the base would not simply close the "tax gap"; instead it would represent a significant change in law for numerous closely-held businesses that are complying currently with the law. (ABA Section of Taxation Comments on Additional Options to Improve Tax Compliance Proposed by the Staff of J. Comm. on Tax'n at 44 (August 3, 2006)).

As stated above, although the purpose of the new GAO study was purportedly to look at compliance challenges for S corporations and their shareholders, based on the questions that were asked by the GAO as well as the comments of GAO members, this study appears, at least in part, to take the position that the self-employment tax should be imposed on some or all of the income of S corporations (and in particular, S corporations that are service corporations).

Because of the comments made by some of the GAO representatives as well as what the group perceived as an implied bias to assume and confirm noncompliance by S corporations, especially in connection with the payment of social security taxes, the group requested that the GAO let them review the Report before it was finalized. However, the Report was issued without the group having an opportunity to review it, and as the group feared, the Report contains several statements that are highly controversial and appear to be quite misleading, including statements that there have been "long-standing problems with S corporation compliance" and that there was misreporting on 68% of S corporation income tax returns. Although not expressly stated, the clear implication of the Report is that S corporations are somehow aberrantly noncompliant and abusive. As will be explained in more detail below, the statements made by the GAO seem unwarranted, based upon the Report itself as well as other publicly available information. Consequently, Tom Nichols submitted a Records Request to the GAO to find out what, if any, evidence had been gathered by the GAO to support these and other controversial conclusions contained in the Report.

To the surprise of the group, the GAO notified Mr. Nichols that the Senate Finance Committee, as the Requester of the Report, ***refused*** to authorize the release of any information relating to the Report. To put it simply, the members of the group were shocked at the response of the GAO and Senate Finance Committee, especially at a time when the President and the Commissioner of the Internal Revenue Service are demanding "transparency" from taxpayers and are stating publicly that the government will also be transparent in its actions. The problem is compounded by the fact that it has now been reported that certain ***closed***

door negotiations relating to the pending health care bills have included discussions of the possibility of imposing the self-employment tax on some or all of the net income of S corporations as a way to raise revenue for these proposals. Since these proposals are being discussed in ***private***, there is not any information available as to what and why such proposals are being made.

Based on the group's analysis of the GAO Report, there are at least several respects in which the noncompliance conclusions set forth in the Report are misleading. First, as stated above, the clear implication of the 68% misreporting rate highlighted in the Report is that S corporations are aberrantly noncompliant with the Tax Code. However, a careful review of page 10 of the Report suggests otherwise. Although it states that "an estimated 68% of the S corporation returns filed for tax years 2003 and 2004 misreported at least 1 item affecting net income," Footnote 22 to the Report indicates that this 68% estimate "includes misclassification adjustments where a taxpayer reports the correct amount but on the wrong line as well as the adjustments where the examiner zeroed out the entire return." Consequently, it appears that simply reporting a deduction amount on the wrong line would constitute "misreporting" for purposes of the 68% noncompliance rate, ***even though it had no impact on the S corporation's taxable income or the overall tax liability of the S corporation's shareholders***. This raises a serious question as to what portion of the 68% "misreporting" percentage genuinely constitutes noncompliance having an actual impact on income tax revenue. Additionally, in the Preliminary Results of the 2003/2004 National Research Program published at the IRS 2009 Research Conference held on July 8, 2009, the indicated net misreporting percentages for S corporations during tax years 2003 and 2004 were 12% and 16%, respectively. This compares favorably with the overall compliance rate for all taxpayers reported in the IRS Strategic Plan 2009-2013. In that Plan, the Voluntary Compliance Rate for tax years 1985, 1992, 1998 and 2001 were reported at between 83.6% to 84.6%. This implies a net misreporting percentage of 15.4% to 16.4%, i.e., somewhat worse than the S corporation noncompliance rate.

The second problem with the 68% "misreporting" percentage appears to be one of scale. In a follow-up telephone conference with Thomas D. Short of the GAO on January 21, 2010, Mr. Short indicated to Mr. Nichols that he thought there was some form of "de minimis" exception, such as $100, for which an item would not be treated as "misreported." Mr. Nichols specifically asked Mr. Short whether this meant if an S corporation reporting $10,000,000 of gross income incorrectly deducted $101 of expense, its return would be included within the "misreporting" category, and Mr. Short said he thought it would be. This obviously raises serious questions regarding the validity of the 68% misreporting percentage, and essentially would result in such statistic being of little value. (If a misclassification constitutes "noncompliance" and there is not a meaningful de minimis exception, it would not be surprising to find a noncompliance rate of 100% on any type of income tax return.)

Finally, it is important to note that the Report cites deduction of ineligible expenses as the most common error. Most certainly, this is not a problem unique to S corporations, but is a problem which is just as prevalent, if not more prevalent, in sole proprietorships, partnerships (including LLCs taxed as partnerships), and C corporations.

It is important to recognize that S corporation status is one of the most popular vehicles for closely-held businesses, and as such, raising taxes on such entities should never be considered lightly, and certainly not on the basis of statistics of questionable validity. Many of these same points were made in a follow-up letter Mr. Nichols sent to the GAO dated January 12, 2010, shortly prior to issuance of the Report. In this regard, the group believes that it is important for there to be at least one structure whereby closely-held businesses can earn entrepreneurial profits and be subject to only one level of tax without the imposition of social security taxes (where such entrepreneurial profits are not attributable to labor). Additionally, increasing marginal rates on such profits at this point in the economic cycle is likely to be counterproductive, and even more so based upon misleading statistics with respect to such entrepreneurs' tax compliance. The critique of the GAO Report discussed above was set forth in a letter dated February 9, 2010, from Stephen R. Looney and Ronald A. Levitt to the Editor of Tax Notes which appeared in the February 22, 2010 issue of Tax Notes Today.

In a letter dated February 22, 2010 published in Tax Notes Today (Tax Notes Today, March 8, 2010), Timothy P. Boling, Chief Quality Officer of the GAO, responded to the criticism set forth above contending that the GAO Report was "objective and fact based." Specifically, the letter stated that the GAO did not seek to "change the substantive law relating to the application of the self-employment tax to S corporations," properly analyzed the IRS's National Research Program Study of S Corporation Compliance in determining the misreporting percentage for S corporations and dismissed the argument that the lack of a meaningful de minimis exception raised serious questions regarding the validity of the 68% misreporting percentage.

Interestingly, the letter additionally states that GAO did not say "S corporations were aberrantly noncompliant" but instead provided the best data available on compliance from the IRS and put it in context. In this regard, the letter states that the noncompliance rate for sole proprietors in 2001 was 70%, which actually exceeded the 68% noncompliance rate for S corporations. One would expect a similar noncompliance rate for partnerships and LLCs.

While the author appreciates the statements made in Mr. Boling's letter, and certainly acknowledges that the GAO Report did not ***expressly*** state that "S corporations were aberrantly noncompliant," the author believes that the GAO Report has been misinterpreted (as the group suspected it would be) to "vilify" S corporations. The author hopes that based upon the group's comments as well as Mr. Boling's response on behalf of the GAO, the Report will be considered in proper context such that it is clear that S corporations are no more noncompliant with the tax law than sole proprietorships, partnerships, LLCs or any other form of business entity.

However, the GAO Report may very well have been a significant factor in the new Medicare tax imposed on certain shareholders' distributive share of an S corporation's operating income under the recently passed health insurance reform legislation, as well as the proposal to impose the self-employment tax on certain S corporations contained in The American Jobs and Closing Tax Loopholes Act discussed immediately below.

13. Section 413 of the American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213 (the "Act"), would have added new Section 1402(m) to subject certain S corporation shareholders to the self-employment tax imposed under Section 1402 on their distributive share of the income of an S corporation. Specifically, Section 1402(m)(1)(a) would have provided that in the case of any "disqualified S corporation," each shareholder of such disqualified S corporation who provides "substantial services" with respect to the "professional service business" referred to in Section 1402(m)(1)(C) must take into account such shareholder's pro rata share of all items of income or loss described in Section 1366 which are attributable to such business in determining the shareholder's net earnings from self-employment.

A disqualified S corporation would have been defined in Section 1402(m)(1)(C) as:

- any S corporation which is a partner in a partnership which is engaged in a professional service business if substantially all of the activities of such S corporation are performed in connection with such partnership; and

- any other S corporation which is engaged in a "professional service business" if the "principal asset" of such business is the "reputation and skill" of three or fewer employees.

Senator Baucus, on June 16, 2010, introduced a new substitute to the House-passed bill which amends the S corporation provision. Unfortunately, the proposed change is minor and will not alter the harmful impact of this provision. Specifically, the proposal as amended by Senator Baucus would change the definition of a "disqualified S corporation" to mean any other S corporation which is engaged in a professional service business ***if "80% or more of the gross income of such business is attributable to the service of three or fewer shareholders of such corporation***."

Section 1402(m)(3) would have defined the term "professional service business" as being any trade or business if substantially all of the activities of such trade or business involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services.

Except as otherwise provided by the Secretary, a shareholder's pro rata share of items of the S corporation subject to the self-employment tax will be increased by the pro rata share of such items of each member of such shareholder's family (within the meaning of Section 318(a)(1)) who does not provide substantial services with respect to such professional service business.

Additionally, Section 1402(m)(2) would provide that in the case of any partnership which is engaged in a professional service business, Section 1402(a)(13) -- which generally exempts limited partners from the self-employment tax -- shall not apply to any partner who provides substantial services with respect to such professional service business.

a. <u>Proposal is Too Broad and Unfairly Taxes Small Businesses Complying with Law</u>. Although the SBCA is certainly in agreement with the Committee's desire to prevent taxpayers from abusing the S corporation structure to avoid payroll taxes (by means of paying unreasonably low compensation to shareholder-employees), this provision will clearly increase taxes on small business owners who are fully complying with the law. This provision does not narrowly close tax loopholes for taxpayers abusing the system, but rather is a multi-billion dollar tax increase on tax-compliant small businesses in the middle of the most difficult economy the United States has faced since the Great Depression.

b. <u>Proposal is Inconsistent with Long-Standing Policy</u>. Historically, employment taxes were intended to be imposed on income derived from labor. The amendments made to Section 1402 by the Act would apply not only to income derived from ***services*** performed by shareholder-employees of S corporations subject to the Act, but would also apply to income derived from ***capital*** by businesses engaged in service businesses. For example, a medical practice may have made significant investments in MRI machines, X-Ray equipment, CT scanners and related equipment, all of which reflect capital investments by the owners that will generate profits not derived by personal services performed by the shareholder-employees. Additionally, the proposal would subject an S corporation's investment in "human capital" to payroll taxes. For example, an S corporation conducting a medical practice may invest substantial sums in the hiring and training of para-professional employees, such as nurse practitioners and physician assistants, who will generate profits for the S corporation not attributable to personal services performed by the shareholder-employees. Existing case law clearly establishes the fact that service businesses (regardless of the number of shareholders of such business) may generate income from sources other than the personal services of the shareholder-employees. See, e.g., *Richlands Medical Association v. Comm'r*, TCM 1990-66, *aff'd without published opinion*, 953 F.2d 639 (4th Cir. 1992), and *Pediatric Surgical Associates, P.C. v. Comm'r*, TCM 2001-81. By blurring the line between income from labor and income from capital, this provision will set the stage for future increases in employment taxes on both service and non-service businesses and income.

c. Provision Contrary to Recently Enacted Health Reform Bill. The new provision would also contradict and reverse the recent decision made by Congress in the new health care reform law. The Health Care and Reconciliation Act of 2010, H.R. 4872, PL 111-152, imposes a 3.8% Medicare tax on the "net investment income" of individual taxpayers having adjusted gross income of more than $250,000 in the case of taxpayers filing a joint return and more than $200,000 for all other taxpayers. The term "net investment income" is defined to include any gross income derived from a trade or business if such trade or business is a passive activity within the meaning of Section 469 with respect to the taxpayer. Consequently, when Congress adopted the new 3.8% Medicare tax on most forms of investment income, ***it specifically exempted active S corporation shareholders and active limited partners***. This provision would effectively reverse that exclusion, subjecting some active shareholders and active limited partners to the 2.9% Medicare tax, and, if their income exceeds the $200,000/$250,000 thresholds, to the additional .9% Medicare tax under the Health Care Bill. In other words, this provision would be a double tax increase on a broad class of small businesses.

d. IRS Already has Tools Necessary to Combat Abusive Situations. The IRS already has all the necessary "tools" in place to combat abusive situations where S corporations are paying their shareholder-employees unreasonably low compensation. The IRS has been very successful in recharacterizing S corporation distributions as wages subject to payroll taxes where taxpayers have taken compensation that was less than reasonable. See, e.g., Rev. Rul. 74-44, 1974-1 C.B. 287; *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 80 (9th Cir. 1990); *Dunn & Clark, P.A. v. U.S.*, 853 F.Supp. 365 (D. Idaho 1994); and *David E. Watson P.C. v. U.S.*, 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010). The answer to stopping this abuse is for the IRS to do a better job enforcing existing law, rather than for Congress to raise taxes on numerous S corporations and shareholders, the large majority of whom who are fully complying with the law. Additionally, the SBCA is not aware of payroll tax abuses (actual or perceived) involving limited partners of limited partnerships, so the inclusion of limited partnerships in the provision is puzzling and appears misdirected.

e. Provision Unfairly Discriminates Against Small Business. The new provision arbitrarily discriminates against small businesses by taxing S corporations with three or fewer key employees at higher tax rates than S corporations that have four or more key employees. There appears to be no good reason to put smaller businesses at a competitive disadvantage vis-à-vis larger businesses; they already lack economies of scale, and provisions like this make it harder for them to compete and survive.

f. Provision Inappropriately Taxes S Corporation Shareholders on Other Family Members' Distributive Share of Income. The provision will not only subject a shareholder who provides "substantial services" to the S corporation to self-employment tax on such shareholder's distributive share of the S corporation's income, but also on the distributive share of the S corporation's income attributable to any other family member who is also a shareholder and who does not provide "substantial services". Consequently, this provision will result in a shareholder being subject to tax on income of other shareholders -- income to which the shareholder being taxed is ***not*** entitled and does not receive (i.e., "phantom income"). For example, assume that a medical practice has as its shareholders a father who has conducted the practice for many years and is now semi-retired. The father owns 99% of the stock of the S corporation, and his son, who does provide substantial services, owns the remaining 1% of the stock of the S corporation. In this situation, this new provision will require the son to pay payroll taxes on 100% of the corporation's income even though the son only owns 1% of the stock of the S corporation and is only entitled to 1% of the funds distributed by the corporation to its shareholders. Such a result seems to unfairly discriminate against family businesses.

g. Provision Would Add Complexity to Tax Law. The new provision would introduce a host of compliance issues, and would add significant complexity and uncertainty for S corporations (and limited partnerships) engaged in professional service businesses. Key examples include:

(1) The definition of the term "professional service business" in the provision has, contrary to decades of prior statutory tax law, been expanded to include lobbying, athletics, investment advice or management, and brokerage services. This arbitrarily exposes numerous closely-held businesses to the self-employment tax without any prior notice. For example, a two-person investment advisory firm or real estate or insurance brokerage firm, will now be subject to a more onerous tax scheme. This will certainly come as a surprise to these small businesses. This certainly cannot be justified on the basis of closing tax loopholes.

(2) The provision uses the undefined term "substantial services" numerous times. How do taxpayers determine what substantial means? How will their advisors be able to advise them on that point? Many taxpayers won't know whether they owe the tax -- that type of uncertainty undermines our tax system, which is premised on voluntary reporting and compliance.

(3) The new provision would require S corporations engaged in a professional service business to determine whether its principal asset is the "reputation and skill" (again, undefined) of three or fewer employees.

S corporations engaged in a professional service business would be required to get valuations of each of their assets in order to determine their principal assets -- such a valuation would be extremely difficult and expensive to obtain, as assets such as reputation and skill are not easily valued.

All of these questions will invite litigation, and are contrary to the long-stated Congressional goal of tax simplification.

In addition to the complexity and uncertainty relating to the new provision itself, the overall effect of the new provision may well be to force small businesses into the much more complex world of partnership taxation, which will not only be burdensome on these small businesses, but which also presents numerous tax pitfalls for uninformed small businesses and, frankly, much greater potential for manipulation by sophisticated taxpayers.

h. Need for S Corporations for America's Small and Family-Owned Businesses. Finally, it is important to recognize that S corporations are one of the most popular vehicles for small and family-owned businesses, and as such, raising taxes on such entities should never be considered lightly, and certainly not without open and informed debate and analysis of the effects of such taxes. There should be at least one structure whereby small and family-owned businesses can earn entrepreneurial profits subject to only one level of tax and not be subject to unlimited payroll taxes.

After several unsuccessful attempts at passage of the American Jobs and Closing Tax Loopholes Act of 2010, the extenders bill with the controversial S corporation offset was defeated.

14. On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, which departs from its immediate predecessor, the American Jobs and Closing Tax Loopholes Act of 2010, most notably in that it does *not* impose self-employment payroll taxes on the pass-through income of S corporation shareholders.

15. The issue of S corporation income and distributions not being subject to FICA or self-employment taxes, whereas wages paid by S corporations to their shareholder-employees are subject to FICA taxes, has been a political "hot potato" for a number of years. Most recently, with the release of Newt Gingrich's tax return, a strong contingent of democrats has once again brought to the forefront the so-called "John Edwards Tax Dodge," claiming that S corporations are being used to allow their shareholders to avoid large payroll taxes. As was discussed in more detail in an article that appeared in Tax Notes Today, whether Newt Gingrich's structure is abusive, is far from clear, and the IRS itself has been schizophrenic in its pursuit of so-called abusive situations. For example, with C corporations, the IRS will maintain that the income is a dividend rather than wages so that it can maximize the double tax that C corporations are subject to, whereas with S corporations, the IRS will claim that the income is wages rather than dividend distributions so that it can collect FICA taxes. See, "Shades of John Edwards in Gingrich Return," 2012 TNT 15-2 (1/24/2012).

16. In response to the release of Newt Gingrich's tax returns, Representative Pete Stark introduced a bill on January 31, 2012 entitled the "Narrowing Exceptions for Withholding Taxes" ("NEWT") Act. See, "Stark

Introduces Bill to Remove Self-Employment 'Tax Dodge,'" 2012 TNT 21-37 (1/31/2012).

17. The latest attempt to impose self-employment taxes on S corporations is contained in the "Stop Student Loan Interest Rate Hike Act of 2012" (S. 2343), which was introduced by Senate Majority Leader Harry Reid, on April 24, 2012. This bill would require taxpayers with incomes of more than $250,000 to pay employment taxes on income received from an S corporation or limited partnership interest in a professional services business. This bill differs from the NEWT Act by adding the $250,000 income threshold and by applying only to businesses that derive 75% of their income from personal services, but is otherwise very similar to the bill proposed by Rep. Pete Stark. These proposals are again merely a rehash of the provision that passed the House of Representatives in 2010 as part of the American Jobs and Closing Tax Loopholes Act of 2010, but which was not passed by the Senate. As discussed above, this provision, as originally introduced in 2010 and as reintroduced in 2012, is not a sound provision and is critically flawed in a number of ways. See Klein and Looney, "Congress Still Considering Imposition of Self-Employment Tax on Certain S Corporation Shareholders," 12 BET 45 (September/October 2010).

H. <u>APPLICATION OF SOCIAL SECURITY TAXES AND NET INVESTMENT INCOME TAX TO S CORPORATIONS</u>

A number of commentators have recently made potentially negative comments regarding non-wage distributions from ''personal service'' S corporations being one of the few paths to receive income untouched by the FICA tax, Self-Employment (SE) tax or new Net Investment Income (NII) tax.[15] First of all it's important to recognize that non-wage distributions from a non-personal service corporation, such as a manufacturing company, are also not subject to these taxes provided the shareholder materially participates in the business. It is also important to recognize that with respect to personal service S corporations, the IRS and the courts can and have recharacterized nonwage distributions as ''wages'' subject to the FICA tax where unreasonably low compensation is being paid to the S corporation shareholders, so that personal service S corporations may not ''avoid'' the FICA tax on amounts distributed as dividends if they are in substance wages (see *Radtke, Spicer Accounting*, and the *Watson* case).

Additionally, both the IRS and the courts expressly recognize that a so-called personal service corporation may indeed produce earnings that are properly characterized as dividend distributions rather than wages (see the recent *Mulcahy* case, as well as the *Pediatric Surgical Associates* and the *Richlands Medical Association* cases). Quite simply, the FICA and SE taxes were meant to only

[15] See Shamik Trivedi, Jeremiah Coder, and Jaime Arora, ''Practitioners Busy With Net Investment Income Tax Regs,'' Tax Notes, Dec. 10, 2012, p. 1149, Doc 2012-25152, 2012 TNT 234-1.

apply to wages of an individual for personal services he or she actually renders, and not to active operating income (profits) of a business paid out as dividend distributions to shareholders. On the other hand, the NII tax was meant to subject certain higher income taxpayers to the 3.8% tax on passive type investment income, not to the profits of a business in which they materially participate. Consequently, any suggestion that the use of S corporations to ‘‘avoid’’ these three taxes is abusive simply misses the mark as entrepreneurial profits of a business not attributable to wages paid for personal services actually rendered by a shareholder were never intended to be subject to any of these three taxes.

Several comments were also made that the NII tax would probably not cause taxpayers to change their business structures to S corporations. The fact is, according to recently published IRS statistics, the number of entities filing S corporation returns already exceeds the number of entities filing returns as partnerships, and the IRS projects that the gap in the number of entities filing as S corporations versus partnerships will continue to grow in the future (See, Document 6292, Office of Research, Analysis and Statistics, Fiscal Year Return Projections for the United States: 2012-2019, Rev. 6/2012). Consequently, S corporations are already one of the most popular types of structures for small businesses, and the new tax on NII should reinforce that.

Finally, although it may be possible for an LLC member or limited partner to materially participate so that his or her distributive share of income would not be subject to the NII tax, that would likely result in that member's or partner's distributive share of the income of the LLC or partnership being subject to the SE tax (*Renkemeyer* and *Howell*), including the increased 3.8% Medicare tax imposed on the self-employment income of higher income taxpayers. The correct answer here does not have so much to do with defining what a limited partner is for SE or NII tax purposes, but rather to apply the test used in the S corporation area, a reasonable compensation test, to LLCs and partnerships.

I. SOCIAL SECURITY TAXES ON S CORPORATIONS OPERATED THROUGH LIMITED LIABILITY COMPANIES

In those situations in which S corporations are the choice of entity for federal tax purposes, it still may be preferable for a number of non-tax reasons to operate for state law purposes as an LLC. One important issue is whether an LLC which has elected to be taxed as an S corporation for federal ***income*** tax purposes will also be taxed as an S corporation for ***Social Security tax*** purposes rather than as a partnership.

An LLC which has elected to be taxed as an S corporation should be subject to the same Social Security tax rules to which S corporations are subject rather than to the self-employment tax rules to which partnerships are subject.

Some practitioners have cited Reg. §1.1402(a)-2(f) as requiring an entity which elects not to be treated as a partnership for federal ***income tax*** purposes to nevertheless be treated as a partnership for ***self-employment tax purposes***. Specifically, Reg. §1.1402(a)-2(f) states that "an organization described in the preceding sentence [defining a "partnership"] shall be treated as a partnership for the purposes of the tax on self-employment income even though such organization has elected, pursuant to Section 1361 and the regulations thereunder, to be taxed as a domestic corporation."[16]

However, it should be noted that the reference in Reg. §1.1402(a)-2(f) to Section 1361 is actually a reference to Section 1361 as in effect ***prior to its repeal in 1966*** by Pub. L. No. 89-389, Section 4(b)(1), April 14, 1966, 80 Stat. 116, which formerly permitted some unincorporated entities to elect to be taxed as domestic corporations. Following the repeal of this former Section 1361, Congress did not "retire" this section number, but many years later (in 1982) used it again for Subchapter S corporations. Consequently, the author does not believe that this regulation in any manner would cause an LLC which has elected to be taxed as an S corporation to be subject to the self-employment tax as if it were a partnership.

IV. UNREASONABLY HIGH COMPENSATION AND S CORPORATIONS

A. INTRODUCTION

One area in which an S corporation could potentially face a challenge by the IRS for unreasonably high compensation relates to the "taxable income" limitation under the built-in gain tax imposed by Section 1374.

B. GENERAL BUILT-IN GAIN TAX RULES

Section 1374 imposes a corporate-level tax on the built-in gains of S corporations that were previously C corporations. Section 1374 as originally enacted applies to built-in gains recognized by a corporation during the 10-year period following such corporation's conversion to S status. Section 1374(d)(7). Reg. Section 1.1374-1(d) provides that the recognition period is the ten-calendar year period, and not the ten-tax year period, beginning on the first day the corporation is an S corporation or the day an S corporation acquires assets under Section 1374(d)(8) in a carryover basis transaction. The tax rate is presently 35% (the highest rate of tax imposed under Section 11(b)) of the S corporation's "net recognized built-in gain." Section 1374(b)(1).

On September 27, 2010, President Obama signed into law the Small Business Jobs Act of 2010, H.R. 5297. Section 2014 of the Act amends Section 1374 to provide for the reduction of the recognition period during which corporations that converted from C corporation status to S corporation status are subject to the built-in gain tax from 10 years to 5 years for taxable years beginning in 2011. Specifically, the text of the amendment is very similar to the temporary reduction

[16] See also, McKee, Nelson and Whitmire, Federal Taxation of Partnerships and Partners (4th Ed. 2007), ¶9.02[5](b), which states that "a partnership that elects not to be treated as a partnership under Subchapter K apparently is nevertheless treated as a partnership for purposes of Section 1402."

from 10 years to 7 years made by the American Recovery and Reinvestment Act of 2009. Pub. L. No. 111-5, 123 Stat. 115 (2/17/2009) The text of the amendment reads as follows:

> (b) Special Rules for 2009, 2010 and 2011. - No tax shall be imposed on the net recognized built-in gain of an S corporation - (i) in the case of any taxable year beginning in 2009 or 2010, if the 7th taxable year in the recognition period preceded such taxable year, or (ii) in the case of any taxable year beginning in 2011, if the 5th year in the recognition period preceded such taxable year.

The amendment is applicable to taxable years beginning after December 31, 2010, and generally raises the same questions as were raised in connection with the reduction from 10 years to 7 years for taxable years beginning in 2009 and 2010. For a discussion of these issues, see Looney and Levitt, "Reasonable Compensation and The Built-In Gains Tax," 68 NYU Fed. Tax. Inst., ¶15.05[1][a], [b]. [c] and [d] (2010). However, it should be noted that the proposed amendment specifically uses the term "taxable year" in connection with the recognition period for taxable years beginning in 2009 and 2010, but only uses the term "5th year" (not taxable year) in connection with the recognition period for a taxable year beginning in 2011. This appears to resolve any ambiguity created by the previous amendment and clarifies that for dispositions in 2009 and 2010, 7 tax years (including short tax years) need to have transpired prior to the year of disposition for the built-in gain tax ***not*** to apply to such dispositions, and that for dispositions in 2011, 5 ***calendar*** years need to have transpired prior to the year of disposition for the built-in gain tax ***not*** to apply to such dispositions.[17]

Most recently, the American Taxpayer Relief Act of 2012 similarly reduced the recognition period for dispositions made in 2012 and 2013 to 5 (calendar) years. Additionally, the American Taxpayer Relief Act of 2012 clarified that if the 5-year recognition period is satisfied for a disposition occurring in 2012 or 2013, such sale will not be subject to the built-in gain tax even if the purchase price will be received over a period of years under the installment sales method.

C. <u>TAXABLE-INCOME LIMITATION</u>

In addition to the limitation placed on the aggregate amount of net built-in gains that may be recognized by an S corporation under the NUBIG limitation, the taxable-income limitation limits the amount of net built-in gains recognized by an

[17] The differences between the express statutory language and the Committee Reports accompanying the 2009 Act raised the issue of whether Congress actually intended to use tax years rather than calendar years in measuring the 7-year recognition period. In fact, Section 2(h) of the Tax Technical Corrections Act of 2009, H.R. 4169, 111 Congress, 1st Session, which was introduced on December 2, 2009, but which did not pass, would have changed the phrase "7th taxable year" to "7th year" in Section 1374(d)(7)(B) retroactively for tax years beginning after 2008. With the passage of the Small Business Jobs Act of 2010, it appears that Congress has conceded that tax years will apply to the special 7-year rule applicable to dispositions in 2009 and 2010 but that calendar years will be used for the special 5-year rule applicable to dispositions made in 2011.

S corporation on an annual basis. Because a corporation's taxable income may serve as the base for the built-in gains tax, the maximum amount of net built-in gains (built-in gains less built-in losses) that must be recognized by an S corporation in a particular tax year within the BIG Period is limited to the amount of the corporation's taxable income for such year (the taxable-income limitation). Section 1374(d)(2)(A)(ii) and Reg. Section 1.1374-2(a)(2).

Any recognized built-in gain that is not subject to the built-in gains tax because of the taxable income limitation must be carried forward and is subject to the built-in gains tax in the S corporation's succeeding tax years to the extent that it subsequently has other taxable income (that is not already subject to the built-in gains tax) for any tax year within the BIG Period. Section 1374(d)(2)(B), as amended by Section 1006(f)(5) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, 102 Stat. 3342 (1988). This modification reduced potential manipulation of timing post-conversion losses to avoid the built-in gains tax on the corporation's NUBIG, and applies only to corporations filing S elections on or after March 31, 1988.

D. ACCOUNTS RECEIVABLE PLANNING OPPORTUNITIES

1. **General**. Because the accounts receivable of a cash-basis corporation are included in determining a corporation's NUBIG, and the collection of such receivables is treated as a recognized built-in gain under Section 1374, the cash-basis corporation, and particularly the cash-basis service corporation, is potentially subject to a substantial tax liability under Section 1374. Consequently, it is imperative that the cash-basis service corporation converting from C corporation status to S corporation status consider all available planning opportunities to minimize the impact of the built-in gains tax with respect to its accounts receivable.

2. **Zeroing Out of Taxable Income**. Since the base of the built-in gain tax is limited to a corporation's taxable income, one method of avoiding the built-in gain tax would be to zero out the corporation's taxable income for the entire 10-year built-in gain period. ***Such a strategy seems inadvisable in that it could very well subject the S corporation to the same unreasonable compensation arguments to which it would have been subject had it remained a C corporation***. An S corporation would be susceptible to an unreasonable compensation argument in this context since the result of recharacterizing amounts paid as compensation to the shareholder-physicians as distributions would be to increase the corporation's taxable income above zero, and thus, subject it to the built-in gain tax.