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S CORPORATION HOT TOPICS

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I. INTRODUCTION

A. CHOICE OF ENTITY STATISTICS

Although LLCs have gained increasing popularity over the last 10-15 years, 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: 2013-2020, Rev. June, 2014):

Statistics Regarding Choice of Entity

	2013 (Actual)	**2015 (Projected)**	**2018 (Projected)**	**2021 (Projected)**
Form 1065	3,685,725	3,774,800	3,893,800	4,042,800
Form 1120S	4,566,216	4,587,500	4,669,400	4,727,400
Form 1120	1,080,099	1,217,200	1,308,900	1,319,300

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 Seventh 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. Commissioner*, 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, several 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. FINAL BACK-TO-BACK LOAN REGULATIONS

A. PROPOSED REGULATIONS

On June 12, 2012, the IRS released the much anticipated proposed regulations addressing basis increases for back-to-back loans made by S corporation shareholders. A back-to-back loan in the S corporation context refers to an arrangement in which an S corporation shareholder borrows funds from an unrelated or related third party, and then lends such funds to the S corporation. A loan can be structured as a back-to-back loan at the outset to enable the shareholder to obtain a basis increase immediately upon the infusion of funds into the corporation, or a back-to-back loan may arise later when a loan that originally was structured as a direct loan from the third party to the S corporation is restructured as a back-to-back loan in order to provide a basis increase for the shareholder.

The preamble to the proposed regulations specifically provides that disputes continue to arise concerning when a back-to-back loan gives rise to an actual economic outlay, in particular whether a shareholder has been made "poorer in a material sense" as a result of the loan. The preamble states that the frequency of disputes between S corporation shareholders and the government regarding whether certain loan transactions involving multiple parties, including back-to-back loan transactions, created shareholder basis of indebtedness demonstrates the complexity and uncertainty about the issue for both shareholders and the government. Consequently, the preamble states that the IRS is issuing the proposed regulations to clarify the requirements for increasing basis of indebtedness and to assist S corporation shareholders in determining with greater certainty whether their particular arrangement creates basis of indebtedness.

In general, the proposed regulations follow the recommendations made by the American Bar Association Section of Taxation that so long as the loan transaction represents bona fide indebtedness of the S corporation to the shareholder, the shareholder should be allowed to increase his basis in the S corporation under Section 1366(d)(1)(B). Significantly, the preamble provides that so long as the purported indebtedness of the S corporation to the shareholder is bona fide indebtedness to the shareholder, the S corporation shareholder need not otherwise satisfy the "actual economic outlay" doctrine for purposes of Section 1366(d)(1)(B). As pointed out in the ABA Tax Section's comments, the application of the actual economic outlay test did not make sense in the back-to-back loan area, and was being applied without any statutory or economic justification.[1]

The proposed regulations do not attempt to provide a standard for purposes of Section 1366 as to what constitutes "bona fide indebtedness." Rather, the preamble provides that general federal tax principles determine whether the indebtedness is bona fide. Although some commentators have been critical of the proposed regulations based on their lack of a definition of what constitutes bona fide indebtedness,[2] the proposed regulations' dismissal of the actual economic outlay test is a huge step forward for taxpayers.

Proposed Reg. Section 1.1366-2(a)(2)(ii) specifically provides that a shareholder does ***not*** obtain a basis increase merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. The proposed regulation provides that when a shareholder makes a payment on bona fide indebtedness for which the shareholder has acted as guarantor or in a similar capacity, based on the facts and circumstances, the shareholder may increase its basis of indebtedness to the extent of such payment. This is consistent with the overwhelming majority of courts which have considered whether shareholders may increase their basis as the result of guarantees of S corporation debt.[3]

The preamble goes on to discuss the so-called "incorporated pocketbook" theory to claim a basis increase in circumstances that involve a loan directly to the S corporation from an entity related to the S corporation shareholder. See *Yates v. Commissioner*, TCM 2001-280, and *Culnen v. Commissioner,* TCM 2000-139. In

[1] See "Comments on Qualification of Debt as Indebtedness of the S Corporation to the Shareholders," in a letter dated July 26, 2010, to IRS Commissioner Douglas Shulman (2010 TNT 143-19); and AICPA Comments on Back-to-Back Loans (May 29, 2009).

[2] See Tridedi, "Practitioners Split on Proposed Regs on Back-to-Back Loans by S Corp Shareholders" (2012 TNT 113-2, June 12, 2012).

[3] See, eg, *Est of Leavitt v Commissioner*, 875 F2d 420 (4th Cir 1989); *Frankel v Commissioner*, 61 TC 343 (1973), *aff'd without published opinion*, 506 F2d 1051 (3d Cir 1974); *Raynor v Commissioner*, 50 TC 762 (1968); *Weisberg v Commissioner*, TCM 2010-55; *Maloof v Commissioner*, TCM 2005-75, *aff'd*, 456 F3d 645 (6th Cir 2006); and *Wise v Commissioner*, TCM 1997-135. But see *Selfe v U.S.*, 778 F2d 769 (11th Cir 1985), holding that a shareholder who guaranteed a loan under the circumstances of the case would be permitted to increase his basis in the S corporation where, in substance, that shareholder had borrowed funds and subsequently advanced them to the S corporation (citing *Plantation Patterns v Commissioner*, 462 F2d 712 (5th Cir 1972)).

those cases, the S corporation shareholder was allowed to increase his basis where the related entity transferred funds directly to the shareholder's S corporation because the related entity was used as the taxpayer's "incorporated pocketbook." The courts found that in substance, the transaction was a loan from the related entity to the shareholder, followed by a loan from the shareholder to the S corporation. Under the proposed regulations, an incorporated pocketbook transaction increases basis of indebtedness only where the transaction creates a bona fide creditor-debtor relationship between the shareholder and the borrowing S corporation.

The preamble also emphasizes that the proposed regulations do not address how to determine the basis of the shareholder's stock in an S corporation ***for purposes of Section 1366(d)(1)(A)***. This will be discussed in more detail below.

Proposed Reg, §1.1366-2(a)(2)(iii) provides four examples of how the regulations operate. In Example 1, A is the sole shareholder of S, an S corporation. A makes a loan to S. The example provides that if the loan constitutes bona fide indebtedness from S to A, A's loan to S increases A's basis under Section 1366(d)(1)(B). Example 1 goes on to provide that the result is the same if A made the loan to S through an entity that is disregarded as an entity separate from A under Reg. §301.7701-3.

Example 2 involves a loan made to S directly from Bank. A guarantees Bank's loan to S. Example 2 provides that no basis increase is allowed as a result of the guarantee until A makes actual payments on the guarantee to the Bank.

Example 3 addresses the classic back-to-back loan transaction. A is the sole shareholder of two S corporations, S1 and S2. S1 loans $200,000 to A, who then loans $200,000 to S2. Example 3 provides that if A's loan to S2 constitutes a bona fide indebtedness from S2 to A, A's back-to-back loan increases his basis under Section 1366(d)(1)(B).

In Example 4, A is the sole shareholder of S1 and S2. S1 makes a loan directly to S2, and subsequently S1 assigns its creditor position in the note to A by making a distribution to A of the note. The example provides that under local law, after S1 distributed the note to A, S2 was relieved of its liability to S1 and was directly liable to A. Example 4 concludes that if the note constitutes bona fide indebtedness from S2 to A, the note increases A's basis under Section 1366(d)(1)(B). Example 4 leaves open the question whether the result would be the same if S2 was not relieved of its liabilities to S1 under applicable local law. See also *Hitchins v Commissioner*, 103 TC 711 (1994).

B. <u>FINAL REGULATIONS</u>

On July 23, 2014, the Department of the Treasury issued Final Regulations on basis increases for back-to-back loans involving S corporations. The Final Regulations adopt the proposed regulations without substantive change, except for changes allowing a retroactive effective date (which is a positive change to the Proposed Regulations) and minor clarifying revisions. The Proposed Regulations (and now the Final Regulations) constitute a vast improvement over the current state of the law which has applied the "actual economic outlay" test and the "poorer in a material sense" concept to determine whether a shareholder is entitled to a basis increase under Section 1366(d)(1)(B). Rather, the Final Regulations allow for a basis increase under Section 1366(d)(1)(B) if the debt running from the S corporation to the shareholder is a "bona fide" debt under general Federal tax principles. In view of the uncertainty and inconsistent judicial decisions regarding basis increases with respect to back-to-back loans, the guidance is welcome and the IRS should be applauded for its response to the request for regulations made by the ABA Tax Section, the AICPA and many tax practitioners, and for its abandonment of the "actual economic outlay" test with respect to back-to-back loans.

The Final Regulations may be relied on by taxpayers with respect to indebtedness between an S corporation and its shareholder that resulted from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before July 23, 2014.

Unfortunately, the Final Regulations did not incorporate the comments made by the ABA Tax Section on the Proposed Regulations. One of the comments that was not adopted was that although the Proposed Regulations expressly reject the application of the "actual economic outlay" test and the "poorer in a material sense" concept in the preamble, the Final Regulations should directly address these concepts in the body of the Regulations. The preamble to the Final Regulations states that the Treasury Department and the IRS believe that the regulations clearly articulate the standard for determining basis of indebtedness of an S corporation to its shareholder, and that further discussion of the actual economic outlay test in the body of the regulations was unnecessary.

The Proposed Regulations also provided an example that where a related corporation assigns its creditor position in a note from another related S corporation to the common shareholder of the two corporations by making a distribution to the common shareholder of the note, the shareholder will be entitled to increase the shareholder's basis where local law provides that such distribution results in the related S corporation's relief of liability to the other related corporation and the related S corporation becoming directly liable to the common shareholder. The ABA Tax Section commented that the Proposed Regulations should be clarified to reflect that even if local law does not operate to relieve the related S corporation of its liability to the related corporation, the common shareholder should still be entitled to increase the shareholder's basis under Section 1366(d)(1)(B). The Final Regulations refused to adopt this comment on the basis that relief of the original liability is an appropriate fact to consider in determining whether the transaction is a bona fide debt. While it may indeed be a factor to be considered, the courts (and IRS agents) may very well misconstrue this example to ***require*** that the original debtor be relieved of liability to be classified as a bona fide debt.

Additionally, although the Proposed Regulations provided several examples of back-to-back loans that result in a shareholder being able to increase his or her basis in the S corporation under Section 1366(d)(1)(B), the Proposed Regulations contained no example of loan restructurings achieved through loan repayments involving a circular flow of funds, and the ABA Tax Section specifically suggested that two examples involving a circular flow of funds be included in the Final Regulations which would result in a basis increase under Section 1366(d)(1)(B). Again, the IRS did not adopt this comment and add the two examples on the basis that there are circumstances in which a circular flow of funds would not result in bona fide indebtedness, and as such, the IRS believed the regulations were adequate as drafted. Again, because of all the confusion in this area demonstrated by the conflicting court decisions, examples of loan restructurings involving a circular flow of funds resulting in a basis increase for a shareholder provided the transaction resulted in bona fide debt running from the S corporation to the shareholder would have been very helpful to taxpayers and tax practitioners. Unfortunately, by not addressing this issue in the regulations, there may be a tendency by courts to simply treat transactions involving a circular flow of funds as ***not*** increasing basis, rather than focusing on whether the debt from the S corporation to the shareholder is bona fide debt, the standard enunciated in the Final Regulations.

Finally, and very importantly, the ABA Tax Section comments requested clarification that the actual economic outlay test should likewise ***not*** be applicable in the context of increases in stock basis under Section 1366(d)(1)(A), in addition to increases in basis for debt under Section 1366(d)(1)(B). The Final Regulations did not adopt this comment either in order to "expedite the finalization of the proposed regulations…" Unfortunately, this also leaves the door open for the IRS to still apply the actual economic outlay test, as it did in *Maguire v. Commissioner*, TCM 2012-160, in cases involving Section 1366(d)(1)(A) rather than Section 1366(d)(1)(B). As pointed out in the ABA Tax Section comments, while it is agreed that a shareholder should not be allowed to increase the shareholder's stock basis under Section 1366(d)(1)(A) by contributing the shareholder's own promissory note to the S corporation (see Rev. Rul. 81-187, 1981-2 CB 167), the IRS and the courts should also ***not*** apply the actual economic outlay test in cases involving Section 1366(d)(1)(A) relating to increases in stock basis. For many, if not most, of the reasons that the "actual economic outlay" test and the "poorer in a material sense" concept are inappropriate to determine a shareholder's basis in indebtedness of the S corporation to such shareholder under Section 1366(d)(1)(B), both of these concepts are probably even more inappropriate to determine an increase in stock basis under Section 1366(d)(1)(A).[4] Therefore, the Final Regulations should have provided that the

[4] See Looney "Back-to-Back Loans and S Corporation Basis: Dazed and Confused," Journal of Passthrough Entities, May-June, 2011.

"actual economic outlay" test also does not apply in determining basis increases under Section 1366(d)(1)(A). The preamble to the Final Regulations also state that the "Treasury Department and the IRS continue to study issues relating to stock basis and may address these issues in future guidance." By not addressing increases in stock basis under Section 1366(d)(1)(A) in the Final Regulations, IRS agents and the courts may very well continue to wrongly apply the actual economic outlay test and the "poorer in a material sense" concept in cases involving increases to stock basis.

III. S CORPORATION EXTENDER PROVISIONS

A. BUILT-IN GAIN TAX

1. **Reduction of Built-In Gain Tax Recognition Period**. One of the more popular provisions found in recent so-called "extenders" bills has been the reduction of the recognition period for the built-in gain tax imposed under Section 1374.

2. **Built-In Gain Tax and Original Recognition Period**. Section 1374 imposes a corporate-level tax on the built-in gain of S corporations that were previously C corporations. Section 1374 as originally enacted applies to built-in gain recognized by a corporation during the 10-year period following such corporation's conversion to S status. Section 1374(d)(7). Reg. §11374-1(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).

3. **American Recovery and Reinvestment Act of 2009 and Small Business Jobs Act of 2010**. 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 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.[5] 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, 2012 and 2013, 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.[6]

4. **The American Taxpayer Relief Act of 2012**. 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.

5. **Camp Proposal**. As discussed below, the Camp Proposal reduces (permanently) the 10-year recognition period for the imposition of built-in gain tax imposed under Section 1374 to five years, effective for tax years beginning after 2013.

6. **Proposed Legislation**. On June 12, 2014, the House passed H.R. 4453, the S Corporation Tax Relief Act of 2014, which permanently reduces the recognition period under the BIG tax to 5 years and also permanently

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[5] For a discussion of these issues, see Looney and Levitt, "Reasonable Compensation and The Built-In Gain Tax," 68 NYU Fed. Tax. Inst., ¶15.05[1][a], [b]. [c] and [d] (2010).

[6] 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.

extends the basis adjustment for S corporations donating appreciated property. Hopefully the Senate will follow suit and this Bill (or a similar Bill) will be signed into law by President Obama.

B. BASIS ADJUSTMENTS TO STOCK OF S CORPORATIONS MAKING CHARITABLE CONTRIBUTIONS OF PROPERTY

1. **Charitable Contributions of Appreciated Property by S Corporations**. Another important extender provision is the rule regarding basis adjustments to stock of S corporations making charitable contributions of appreciated property. This rule basically permits S corporations to take charitable contributions for the fair market value of the property even where the shareholders of the S corporation do not have sufficient basis to allow for the pass through of such losses.

2. **Pension Protection Act of 2006**. The Pension Protection Act of 2006 amended Section 1367 to provide that when an S corporation contributes appreciated property to a qualified charity, a shareholder may reduce his or her stock basis by the shareholder's pro rata share of the adjusted basis of the property contributed (as opposed to the property's fair market value). Although the Pension Protection Act amended Section 1367 regarding basis adjustments for charitable contributions of appreciated property, it did not amend the basis limitation rules of Section 1366(d) correspondingly, and as such, left in doubt the ability of S corporation shareholders to deduct shareholder contributions of appreciated property.

3. **Tax Technical Corrections Act of 2007**. The Tax Technical Corrections Act of 2007 amended Section 1366 to clarify that the Section 1366(d)(1) basis limitation on pass-through S corporation losses does not apply to a charitable contribution of appreciated property to the extent the shareholder's pro rata share of the fair market value of the contribution exceeds the shareholder's pro rata share of the property's adjusted basis.

4. Emergency Economic Stabilization Act of 2008Section 307 of Division C of the Emergency Economic Stabilization Act of 2008 (the "2008 Act"), extended the temporary rule of Section 1367 to contributions made through December 31, 2009.

5. **The Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010 and the American Taxpayer Relief Act of 2012**. The Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended this rule to chartable contributions occurring in 2010 and 2011, and the American Taxpayer Relief Act of 2012 once again extended this rule to charitable contributions occurring in 2012 and 2013.

IV. REPRESENTATIVE CAMP'S PROPOSAL

A. TAX REFORM ACT OF 2014

On February 26, 2014, House Ways and Means Chairman, Dave Camp (R-MI), released a 979-page "Tax Reform Act of 2014" discussion draft (the "Camp Proposal"). The Camp Proposal contains sweeping, sometimes surprising, and controversial changes to both individual and business taxation, that if enacted, will have a dramatic effect on many businesses, including professional service businesses such as medical practices.

This outline will briefly summarize ***select*** business and individual tax reform proposals contained in the Camp Proposal.

B. INDIVIDUAL TAX PROPOSALS

1. **Tax Rates**. The linchpin of the Camp Proposal is the reduction of both individual and corporate tax rates. Although Representative Camp has stated that there are only two tax brackets for individuals under his proposal, plus an additional 10% "surtax," the 10% surtax will likely be viewed by most people as a third tax bracket. The tax rate changes, as well as most of the other changes contained in the Camp Proposal would become effective January 1, 2015.

   A 10% tax bracket would apply on adjusted gross income ("AGI") up to \$71,199, and the 25% tax bracket would apply to AGI from \$71,200 up to \$450,000 for married taxpayers filing jointly and up to \$400,000 for other taxpayers. The new 35% tax bracket, or 10% "surtax" as Representative Camp prefers to refer to it, applies to a different tax base referred to as "Modified Adjusted Gross Income" ("MAGI"), which is much broader than AGI, and includes items such as tax-exempt interest, employer-sponsored health insurance payments, self-employed health insurance deductions, pre-tax contributions to defined contribution retirement plans and medical savings account deductions. The 35% tax rate, which also works in conjunction with the phase-out of the 10% tax bracket, applies to married taxpayers having MAGI of more than \$450,000 and to other taxpayers having MAGI of more than \$400,000.

   Consequently, taxpayers who have MAGI greater than \$450,000 (for married taxpayers filing jointly) or greater than \$400,000 (for all other taxpayers) will be subject to a tax of 25% on their AGI up to those threshold amounts, and then subject to a 35% tax rate on MAGI in excess of such amounts. When compared to the current maximum marginal rate of 39.5%, the maximum marginal individual tax rate of 35%, which applies to a broader base of income than the current 39.5%, combined with the effect of the elimination of many deductions and credits, will result in many taxpayers paying higher effective tax rates under the Camp Proposal than they do under current tax law.

2. **<u>Capital Gains and Dividends</u>**. Under current law, capital gains and dividends are subject to a maximum marginal tax rate of 20%. Under the Camp Proposal, 40% of capital gains and dividends generally will be excluded from a taxpayer's income, with the remaining 60% subject to taxation at the ordinary income tax rates of 10%, 25% and 35%.

3. **<u>Changes to Contribution Limit on Pre-Tax Contributions to Section 401(k) Plans</u>**. The Camp Proposal reduces by one-half the existing limits on employee pre-tax contributions to Section 401(k) plans, with the remaining one-half eligible to be contributed ***on an after-tax basis*** to a Roth account. The combination of including pre-tax contributions to 401(k) plans in MAGI subject to the 35% tax bracket and reducing the contribution limits available to employees on a pre-tax basis to Section 401(k) plans would seem to have a very negative impact on the ability of individuals to save for retirement.

C. <u>CORPORATE TAX, PASS-THROUGH ENTITY AND OTHER BUSINESS TAX REFORMS</u>

1. **<u>Corporate Tax Rates</u>**. The Camp Proposal eliminates the current tax brackets ranging from 15% to 35% for C corporations, in favor of a single 25% rate.

   Although this reduction to a flat 25% rate might at first appear beneficial to personal service corporations such as physician practices, if the "C" corporation medical practice distributes earnings as dividends to its shareholder-physicians, the effective double tax rate on such earnings will be 42.85% and such earnings could also be subject to state corporate income taxes. Thus, it would still appear to be more tax efficient to operate a professional practice in a pass-through entity, such as an S corporation, rather than in a C corporation.

   Under the Camp Proposal, while large publicly-held and multi-national corporations taxed as C corporations, will enjoy a flat tax rate of 25%, the majority of America's small businesses which conduct their businesses through S corporations, partnerships, LLCs and sole proprietorships, will be subject to the three bracket system to which individuals are subject, and as such, will be subject to a top marginal tax rate of 35%. Combined with the elimination of many business deductions and credits by the Camp Proposal, this could have a crippling effect on America's small businesses and have a substantial adverse effect on the economy.

2. **<u>Use of Cash Method of Accounting</u>**. Under current law, S corporations, partnerships (without C corporation partners), and qualified personal

service corporations are allowed to use the cash method of accounting as opposed to the more complicated accrual method of accounting. Under the Camp Proposal, although businesses with average annual gross receipts of $10 million or less could continue to use the cash method of accounting, businesses, including pass-through entities, with more than $10 million of gross receipts would be required to use the accrual method of accounting. This will include many flow-through entities currently able to use the simpler cash method of accounting.

3. **Social Security Taxes**. As will be discussed in more detail below, the Camp Proposal includes a shocking change which imposes the self-employment tax ("SECA") on S corporation shareholders (and partners of a partnership) who materially participate in their businesses within the meaning of Section 469. The Camp Proposal generally subjects 70% of the combined compensation and the distributive share of an S corporation's (or partnership's) combined and distributive share of the entity's income as net earnings from self-employment subject to FICA or SECA, as applicable.

D. FAVORABLE CHANGES TO S CORPORATION RULES

A number of other changes are made to the rules governing taxation of S corporations by the Camp Proposal, all of which are favorable to S corporations. The built-in gain tax period under Section 1374 for C corporations converting to S corporation status would be permanently reduced from 10 calendar years to 5 calendar years. As discussed in more detail above, under the American Taxpayer Relief Act of 2012, the built-in gain period was reduced to 5 years for dispositions occurring in 2012 and 2013.

The tax on excess passive income proposed under Section 1375, which currently applies to S corporations where more than 25% of their gross receipts constitute passive investment income would be amended so that the Section 1375 tax on excess passive investment income would not apply to an S corporation unless more than 60% of the S corporation's gross receipts constitute passive investment income. Additionally, existing Section 1362(d)(3) would be repealed so that having excess passive investment income for three consecutive tax years (and having Subchapter C earnings and profits) would ***not*** terminate a corporation's S election.

Under the Camp Proposal, qualifying beneficiaries of an electing small business trust ("ESBT") would be expanded so that non-resident aliens could be potential current beneficiaries of ESBTs, and ESBTs would be allowed to take charitable contribution deductions in much the same manner as individuals.

The Camp Proposal would also make permanent the rule regarding basis adjustments to stock of S corporations making charitable contributions of property as discussed above.

The Camp Proposal additionally extends the time for making S corporation elections from the existing two months and fifteen day period following the election of S corporation status, to the due date for the corporation's first tax return as an S corporation. Additionally, the Camp Proposal allows the IRS to treat a late revocation of an S corporation election as timely if there were reasonable cause for the failure to have timely filed the revocation.

E. CONCLUSION

While the Camp Proposal does contain a number of provisions favorable to taxpayers, and appears to simplify the tax code by eliminating a multitude of individual and business deductions/credits currently available to individuals and businesses, it would appear that the overall impact of the Camp Proposal would favor large publicly-traded C corporations, but would likely have a very detrimental effect on individuals and pass-through entities such as S corporations, through which most of America's small businesses are operated.

V. UNREASONABLY HIGH COMPENSATION AND C CORPORATIONS

A. STATUTES AND REGULATIONS

In order to properly analyze reasonable compensation in the S corporation context, it is helpful to review reasonable compensation in the C corporation context, where most of the case law is found.

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.

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. <u>COMPENSATORY INTENT</u>

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. Commissioner*, 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. Commissioner*, 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. Commissioner*, 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. Commissioner*, 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. Commissioner*, 74-2 USTC ¶9701 (9th Cir. 1974).

C. <u>REASONABLENESS OF COMPENSATION AND THE MULTI-FACTOR TEST</u>

The leading case in the unreasonable compensation area is *Mayson Manufacturing Co. v. Commissioner*, 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. Commissioner*, 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.

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."

2. **<u>Dexsil Corp</u>**. In *Dexsil Corp. v. Commissioner*, 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. Commissioner*, 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.

3. **<u>Exacto Spring Corp</u>**. Other circuits have adopted the independent investor test as set forth by the Second Circuit in *Dexsil*. In *Exacto Spring Corp. v. Commissioner*, 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*."

E. <u>RECENT CASES DETERMINING REASONABLE COMPENSATION</u>

1. **<u>The *Menard* Case</u>**. In *Menard, Inc. v. Commissioner*, 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.

2. **The *Multi-Pak Corp.* Case**. In *Multi-Pak Corp. v. Commissioner*, 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.

3. **The *Mulcahy* Case - Independent Investor Test Applied to Professional Service Corporation**. In *Mulcahy, Pauritsch, Salvador & Co.*, 680 F.3d 867 (7th Cir. 2012), 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.

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."[7]

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."

[7] See also, *Kennedy v. Commissioner*, 671 F.2d 167 (6th Cir. 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.

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 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*, TCM 1990-660, and *Pediatric Surgical Associates, P.C.* TCM 2001-81. 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%.[8]

4. ***<u>Thousand Oaks Residential Care Home I, Inc.</u>*** In *Thousand Oaks Residential Care Home I, Inc. v. Commissioner*, 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

[8] 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.

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 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. This should be contrasted with the *Aries* case discussed above which also found a return of 10%-20% reasonable, but still found a portion of the compensation in that case to be unreasonable based on the application of the multi-factor test.

5. ***K&K Veterinary Supply***. In *K&K Veterinary Supply v. Commissioner*, TCM 2013-84, the Tax Court, siding with the IRS's expert, recharacterized a portion of the salaries paid to the sole shareholder of a C corporation and to other members of his family, as well as rental payments made by the Corporation to another entity wholly owned by the shareholder, as non-deductible dividends.

The C corporation was a wholesale distributor of animal health products for large animals, swine, sheep, goats and horses; lawn and garden products; farm hardware; pet supplies; and products for farm stores and related dealers. The corporation was wholly owned by Jay Lipsmeyer, who served as president, co-chief executive officer and co-chief operating officer of the corporation. His wife, Melissa Lipsmeyer, served as vice president, secretary, and assistant chief financial officer of the corporation, while his brother, David Lipsmeyer, served as the corporation's senior vice president of sales and co-chief executive and co-chief operating officer). Jay Lipsmeyer's daughter, Jennifer Stewart, served as the corporation's chief financial officer.

In a departure from some recent opinions applying the so-called "independent investor" test,[9] the court, in determining reasonable compensation, applied the so-called multi-factor test to determine reasonable compensation for the officers of the corporation, rather than the so-called "independent investor" test. Citing *Charles Snyder & Co.v. Commissioner*, 500 F2d 48 (8th Cir. 1974), *aff'g* TCM 1973-130, the court stated that various factors should be considered in determining the reasonableness of compensation, such as: (1) the employee's qualifications, (2) the nature, extent and scope of the employee's work, (3) the size and complexity of the business, (4) prevailing general economic conditions, (5) the employee's compensation as a percentage of gross and net income, (6) the employee-shareholder's compensation compared with distributions to shareholders, (7) the employee-shareholder's compensation compared with that paid to non-shareholder employees, (8) prevailing rates of compensation for comparable positions in comparable concerns, and (9) comparison of compensation paid to a particular shareholder-employee in previous years where the corporation has a limited number of officers. The court additionally stated that special scrutiny must be given to situations where a corporation is controlled by the employees to whom the compensation is paid because there is a lack of arms-length bargaining.

In reaching its decision, the Tax Court evaluated all of these factors, and looked primarily to the testimony given by the expert witnesses. After considering the reports of the taxpayer's expert and the IRS's expert, the court found the IRS expert's report persuasive and accepted his conclusions as to reasonable compensation for each of the officers for the years in issue, 2006 and 2007, which resulted in the balance of the compensation being treated as non-deductible dividend distributions to the sole shareholder.

The court then considered the deductibility of the rental payment made by the corporation to the related entity owned by the sole shareholder of the corporation. The court stated that in determining whether the payments in issue were rental payments deductible under Section 162(a)(3), the "basic question is … whether they were in fact rent rather than something else

[9] See, e.g., *Menard Inc. v. Commissioner*, 560 F.3d 620 (7th Cir. 2009); *Multi-Pak Corp. v. Commissioner*, TCM 2010-139; *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, 680 F.3d 867 (7th Cir. 2012); and *Thousand Oaks Residential Care Home I, Inc. v. Commissioner*, TCM 2013-10.

paid under the guise of rent."[10] Again, the taxpayer had his own expert as to whether the rental payments were reasonable and the IRS had its own expert testify as to whether the rental payments were reasonable. Once again, the court accepted the position taken by the IRS's expert as to reasonable rent, and treated the balance of the rental payments as non-deductible dividends to the sole shareholder of the corporation.

6. **Aries Communication, Inc**. In *Aries Communication, Inc. v. Commissioner*, TCM 2013-97, the Tax Court held that the compensation paid to a communications corporation's sole shareholder was unreasonable and upheld an accuracy-related penalty. The tax year at issue is the fiscal year ending August 31, 2004.

The case involved compensation paid to N. Arthur Astor (Astor), the president, CEO, CFO, and sole shareholder of Aries Communications Inc. in his capacity as general manager of a number of radio stations owned by Aries and its subsidiaries, Orange Broadcasting Corp. and North County Broadcasting (collectively, Aries). Astor had worked in radio broadcasting in various capacities for 60 years. As the key employee and hands-on owner-operator, Astor made decisions regarding personnel, programming, sales, and acquiring and maintaining FCC licenses, and he negotiated directly with lenders and outside advisors.

Astor's personal services also included negotiating purchases and sales of individual radio stations, resulting in prices far exceeding the buyers' original offers (e.g., increased to $18 million from $12 million). Astor personally guaranteed a $20 million loan for Aries, which precipitated the sales of two radio stations as part of a forbearance agreement with the lender. There were a number of interparty loans between Astor and Aries.

Between the years 1992 and 2002, Aries was losing increasing amounts of money. It sold a radio station in each of the years 2003 and 2004 and was profitable in those years; however, Aries began losing money again in the succeeding years.

For the year at issue, fiscal year 2004, the IRS disallowed $6,086,752 of Aries' claimed Section 162 deduction for compensation paid to Astor, and determined a deficiency of $2,676,002 and a Section 6662(a) accuracy-related penalty of $535,200.40. Aries petitioned the Tax Court and argued in part that the amount paid to Astor in fiscal year 2004 included catch-up amounts for the three prior years; thus, the court evaluated the reasonableness of Astor's compensation for FY 2001 through FY 2004.

[10] *Place v. Commissioner*, TC 199 (1951), *aff'd per curium* 199 F2d 373 (6th Cir. 1952).

The court determined that there is no doubt that Astor was the most valuable employee of Aries, and that at least a portion of the compensation paid to him was for services actually rendered.

To determine whether the compensation was reasonable, the court applied the five factors enunciated by the court in *Elliotts*:

1. The employee's role in the company.

2. A comparison of the employee's salary with salaries paid by similar companies for similar services.

3. The character and condition of the company.

4. Potential conflicts of interest.

5. Internal consistency.

The court also applied an additional factor: Whether an independent investor would be willing to compensate the employee as the taxpayer compensated the employee, based on all the facts and circumstances.

With respect to the first factor (the employee's role in the company), the court determined that Astor was a hands-on owner-operator actively involved in managing many aspects of Aries' day-to-day operations. His business acumen and experience resulted in successful investments for Aries, including acquisition of FCC licenses and the successful sales of two radio stations. The first factor thus weighed in favor of Aries.

For the second factor (comparison with similar companies' salaries), the parties provided experts with divergent opinions regarding reasonable compensation. Aries provided two experts and the IRS provided one expert, each of which used linear regression as a tool to compare industry income and compensation. The experts agreed that external comparisons were difficult because Aries was one of the few companies in the industry in which the owner was also the operator, and that Astor was underpaid during the four years evaluated by the court. The experts also agreed that Astor's salary was underpaid in previous years, and the court averaged their conclusions. However, the experts disagreed regarding the reasonableness of the $6,697,700 bonus paid to Astor during the year at issue. The court, using its judgment and based on the evidence in the record, determined that an appropriate bonus would be $2 million. This factor weighed against Aries.

For the third factor (character and condition of the company), the court found that Aries was a large asset-laden complex business holding multiple subsidiaries, each with its own radio station. The court noted that Aries lost money in all years except the years it sold radio stations, that it was deeply in debt, and that it had to borrow money from Astor even during the year it paid him the bonus at issue. The court concluded that this bleak financial situation suggested that Aries was thinly capitalized, and cast a shadow on the substance of the transaction. This factor also weighed against Aries.

The fourth factor (potential conflicts of interest) concerns whether a relationship exists between the employee and the company that may permit the disguise of nondeductible corporate distributions as salary expenditures. Noting a lack of specific evidence in the record regarding whether Aries had ever paid dividends to Astor, the court determined that such a relationship did exist. Also, the various related-party loans and Astor's personal guarantee of the $20 million debt made it difficult to discern the true capital structure and equity status of the corporate entities. Further, although Astor negotiated the highest price for the sale of the radio station, just as an independent investor would, he had significant interest in receiving the reward as deductible salary instead of a nondeductible dividend. This factor again weighed against Aries.

The court found the fifth factor (internal consistency) to be neutral. The court found the amount of Astor's bonus to be "suspect" because it was not paid under a structured formal plan and was determined the end of the year when Aries' profits and potential income tax liabilities could be predicted. However, no employees within the corporation had comparable duties, and the compensation included amounts for prior years of hard work for which he was undercompensated.

Finally, with respect to the additional factor (the independent investor), the court considered what a reasonable return on investment for a hypothetical independent shareholder would be. Citing case law, the court determined that a return on investment of 10%-20% tends to indicate compensation is reasonable. Aries was a highly leveraged business but possessed assets, such as the FCC licenses, that were likely to appreciate. Further, it was unclear from the record what Astor's initial investment was and the interparty loans made it difficult to determine the return on investment. Nevertheless, the court's review of Aries' net income after paying compensation revealed that retained earnings would have been almost enough to satisfy an independent investor at 20%. This factor weighed in favor of Aries.

Based on all the facts and circumstances, the court concluded that Astor's compensation was unreasonable for the year at issue, and not deductible to Aries in its entirety. The court computed an amount that was deductible, based on the average underpaid salaries for previous years plus the actual fixed salary, and a $2 million bonus that was determined reasonable for the year at issue. Regarding the Section 6662(a) accuracy-related penalty, the court noted that Aries did not provide any evidence of reasonable cause; accordingly, the penalty was upheld.

If this case had been decided exclusively under the independent investor test discussed below, which many courts have more recently favored, it would appear that a different result would have been reached in *Aries* and all of the compensation would have been treated as reasonable compensation.

7. **Independent Investor Test Being Used More Frequently**. Based upon a number of these recent cases, including the *Menard*, *Multi-Pak*, *Mulcahy*, and *Thousand Oaks* cases, the courts seem to be putting more emphasis on the independent investor test (than the multi-factor test) in determining the reasonableness of compensation. However, it is important to recognize that unlike the multi-factor test, the independent investor test only seems appropriate in determining whether compensation is unreasonably high rather than whether compensation is unreasonably low in the S corporation context.

VI. EMPLOYMENT TAX ISSUES

A. THE SELF-EMPLOYMENT TAX

For 2014, 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 $117,000 of such net earnings, and 2.9% on amounts in excess of $117,000. For 2015, the $117,000 is increased to $118,500. (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 tax on the net investment income of individuals, partners, members of LLCs taxed as partnerships and S corporation shareholders. Specifically, Section 1411(a)(1) imposes a 3.8% 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% net investment income 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, a partner, ***including a limited partner***, LLC member and an S corporation shareholder, will be subject to the new 3.8% net investment income 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.

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

The new 3.8% 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. 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).[11]

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.[12]

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."[13]

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 federal income tax purposes, by default it was taxed as a partnership.[14] 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.

[11] See Ltr. Ruls. 9432018, 9452024 and 9525058.
[12] See Tax Notes, July 19, 1999, at 469.
[13] BNA's Daily Tax Report (Friday June 13, 2003), G-3.
[14] Reg. §301.7701-3(b)(1)(i).

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.

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. Commissioner,* 132 TC 19 (2009), *Gregg v. U.S.,* 186 F.Supp.2d 1123 (D. Or. 2000), and *Newell v. Commissioner*, 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 net investment income 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 Section 469.

6. **Implication of *Thompson* Case on Self-Employment Tax to LLC Members**. 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. **The *Robucci* Case**. In *Robucci v. Commissioner*, TCM 2011-19, the Tax Court applied the two-pronged Moline Properties (*Moline Properties v. Commissioner*, 319 U.S. 436, 30 AFTR 1291 (1943)) test to disregard two corporations created by a psychiatrist (on the advice of his attorney/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. **<u>The *Renkemeyer* Case</u>.** In *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 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. Commissioner*, 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.

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.

While the Tax Court held that Mrs. Howell was subject to SE Tax with respect to her guaranteed payments, it did not strictly follow *Renkemeyer* (which would have required a holding that Mrs. Howell was not a limited partner). Instead, holding Mrs. Howell to the form of transaction she chose, the court concluded that the record established that Mrs. Howell performed services for their LLC and that she was not a passive investor, that the payments made to her were for services rendered and that Mrs. Howell did not satisfy her burden of proving that such payments did not constitute payments for services rendered.

Observation. 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, 1959-1, CB 225, 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 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)**.**[15]

10. **The *Riether* Case**. In *Riether v. Commissioner*, 919 F. Supp. 2d 1140, 112 AFTR2d 2013-6074 (DC N.M. 2012), the court rejected on summary judgment a radiologist's and his wife's claim that they were not liable for self-employment tax on their distributive share of income from a diagnostic imaging LLC taxed as a partnership. Although not clear from the facts of the case, presumably all of the income of the diagnostic imaging LLC was attributable to the "facility fee or "technical component" of the imaging services provided. by the LLC rather than for. professional medical (reading) services.

The LLC actually issued W-2s to husband and wife showing salaries or wages paid by the LLC to each of them for a portion of the LLC's income. For the balance of the LLC's income, K-ls were issued to husband and wife on which they did not pay self-employment tax.

Citing Rev. Rul. 69-184, 1969-1 CB 256, the court stated that the LLC should have treated all of the LLC's income as self-employment income, rather than characterizing some of it as wages. Specifically, Rev. Rul. 69-184 states that members of a partnership are not employees of the partnership for purposes of self-employment taxes. Rather, a partner who participates in the partnership business is "a self-employed individual." The court found that the LLC's improper treatment of the "wages" income further undermined the taxpayers' simplistic argument that they owed no self-employment taxes simply because they received W-2s.

The taxpayers also argued that the income of the LLC was "unearned income," and as such, was not subject to the self-employment tax. The court stated that simply labeling income as "unearned income" does not exempt such amounts from the self-employment tax. Rather, the court reiterated that the self-employment tax applies to a taxpayer's distributive share of all partnership income with only certain limited exceptions. Citing Section 1402(a)(13), which exempts from the self-employment tax

[15] 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).

a limited partner's distributive share of income from a limited partnership, and the *Renkemeyer* case, the court concluded that the taxpayers were not members of a limited partnership, nor did they resemble limited partners, which are those who "lack management powers but enjoy immunity from liability for debts of the partnership." Thus, whether the taxpayers were active or passive in the production of the LLC's earnings, those earnings were self-employment income, subject to the self-employment tax.

11. **<u>CCA 201436049</u>**. In CCA 201436049 (9/5/2014), the IRS found that members of a management company LLC ("Management Company") were not "limited partners" within the meaning of Section 1402(a)(13) and therefore were subject to the self-employment tax on their distributive shares of income of the Management Company.

Under the facts of the ruling, a limited liability company classified as a partnership for federal tax purposes served as the investment manager for "*Managed Fund*," a family of investment partnership funds that carry on extensive trading and investing activity (the "Funds").

The Management Company generally has full authority and responsibility to manage and control the affairs and business of the Funds. The Management Company is primarily responsible for carrying out the extensive market research and trading activity of each of the Funds, and carries on all investment activities, such as the purchasing, managing, restructuring and selling of the Funds' investment assets. Members of the Management Company and its employees provide these extensive services to the Funds. The Management Company's primary source of income is from fees for providing management services to the Funds. In consideration of the Management Company's services, the limited partnership agreements of each of the Funds provide for payment of a quarterly "management fee" from the Funds to The Management Company. For the years in issue, the Management Company's gross receipts were entirely attributable to management fees for providing services to the Funds, and the Management Company's ordinary business income was comprised entirely of income from management fees.

Additionally, in the years in issue, each member of the Management Company worked full time for the Management Company, performing a wide-range of professional services. Each of the members receives a Form W-2 from the Management Company for specified wage amounts.

For the years in issue, the Management Company treated all of its members as "limited partners" ***not*** subject to the self-employment tax on their distributive share of the Management Company's income. The only amounts reported as subject to self-employment tax were guaranteed payments representing health insurance premiums and parking benefits paid on behalf of the members by the Management Company.

The Management Company argued that the "***wage***" amounts represent "***reasonable compensation***" for each member of the Management Company, and that each member is a limited partner with respect to their distributive share of the income of the Management Company. The Management Company reasoned that because the Management Company has the same role in the business as the S corporation it succeeded, it can continue to apply the same "***reasonable compensation***" wage rules applicable to S corporations.

The ruling relies heavily on the legislative history behind Section 1402(a)(13) and the *Renkemeyer* and *Riether* cases discussed above.

Specifically, Section 1402(a)(13) provides that there shall be excluded from self-employment income the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in Section 707(c) to that member for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

The legislative history for the exception in Section 1402(a)(13) clarifies that Congress did not intend to allow service partners in a service partnership acting in the manner of self-employed persons to avoid paying self-employment tax. The ruling goes on to cite the *Renkemeyer* case, in which the Tax Court found that the attorney-partners of an LLP engaged in the practice of law who were lawyers performing services for the LLP were not limited partners within the meaning of Section 1402(a)(13) for purposes of excluding their distributive share of the income of the LLP from the self-employment tax. The Tax Court in *Renkemeyer* went on to provide that the share 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***."

The ruling goes on to cite the *Riether* case discussed above, where the court granted the government's motion for summary judgment on the issue of whether a husband and wife were subject to self-employment tax on their distributive share of income from an LLC. In the *Riether* case, the court concluded that Section 1402(a)(13) only applies to limited partners and not to taxpayers treated as a general partner, "***irrespective of the nature of his membership***." The court went on to find that the taxpayers were not members of a limited partnership, nor did they resemble limited partners, which are those who "***lack management powers but enjoy immunity from liability for debts of the partnership***." The *Riether* case concluded that ***whether the taxpayers were active or passive in the production of the LLC's earnings, those earnings were self-employment income subject to the self-employment tax***.

The ruling goes on to provide that the Management Company's members performed extensive investment and operational management services for the Management Company in their capacity as members (i.e., acting in the manner of self-employed persons) and that the Management Company derives its income from the investment management services performed by its members. The IRS concluded that the income earned by the members through the Management Company was not income which was "basically of an investment nature" of the sort that Congress sought to exclude from self-employment tax when it enacted the predecessor to Section 1402(a)(13). Additionally, the IRS stated that like the situation in *Renkemeyer*, the members' earnings were not in the nature of a return on capital investment, even though the members paid more than a nominal amount for their membership interests. Rather, the IRS found that the earnings of each member from the Management Company were a direct result of the services rendered on behalf of the Management Company by such members. The IRS also stated that similar to *Riether*, the Management Company cannot change the character of its members' distributive shares by paying a portion of each member's distributive share as amounts mislabeled as so-called "***wages,***" citing Rev. Rul. 69-184, 1969-1, C.B. 256.

Finally, the IRS expressly stated that because The Management Company was not an S corporation, the "***reasonable compensation***" rules applicable to S corporations do not apply (which will be discussed below and are a major advantage of operating as an S corporation rather than as an LLC).

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. **<u>Social Security Taxes on Wages</u>**. 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 is $117,000 for 2014 and $118,500 for 2015.

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% net investment income tax.

2. **<u>Social Security Taxes and S Corporations</u>**. 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 "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 PLR 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. [16]

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 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. **S Corporations and Unreasonably Low Compensation - Reclassification Risks.**

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

[16] 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).

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.[17]

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 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. Commissioner*, 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.

[17] 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).

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. Commissioner*, 56 TC 1324 (1971); *Paula Construction Co. v. Commissioner*, 58 TC 1055 (1972), and *Pediatric Surgical Associates, P.C. v. Commissioner*, 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 Section 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. Commissioner*, 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.

f. *In Herbert v. Commissioner,* 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 *Mayson Manufacturing Co. v. Commissioner*, 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).

g. In *Sean McClary Ltd., Inc. v. Commissioner*, TC Summ. Op. 2013-62, the Tax Court recharacterized the distributions made by an S corporation to its sole shareholder as wages subject to Social Security taxes where the shareholder received no salary from the S corporation and also found that the annual compensation formula contained in the Board of Directors minutes setting a salary of $24,000 was unreasonably low.

Mr. McClary was the president, secretary, treasurer, sole director and sole shareholder of his S corporation. He managed all aspects of the S corporation's operations, including recruiting and supervising sales agents, conducting real estate sales, procuring advertising, purchasing supplies, and maintaining basic books and records, Mr. McClary often worked 12-hour days with few days off. For the year in issue, Mr. McClary supervised eight sales agents, four of whom generated sales commissions for the S corporation that year, but most of the S corporation's gross receipts were attributable to sales commissions generated by Mr. McClary himself.

For the year in issue, the S corporation did not issue a form W-2, Wage and Tax Statement, to Mr. McClary, nor did it claim a deduction for the amount paid to Mr. McClary as wages or compensation for services. During such year, Mr. McClary transferred a total of $240,000 from the S corporation's account to his personal account.

In determining what portion of the $240,000 of distributions should be recharacterized as wages, the IRS's expert witness found that $100,755 represented reasonable compensation for services rendered by Mr. McClary for the year in issue. On the other hand, Mr. McClary argued that even though he did not pay himself a salary, the salary of $24,000 set forth in the compensation arrangement in the corporation's minutes should be the only amount characterized as wages subject to Social Security taxes.

The Tax Court, citing the multi-factor test used in determining reasonable compensation for shareholder employees of C corporations, found that reasonable compensation for Mr. McClary's services during the year in issue was $83,200, and as such, recharacterized $83,200 of the $240,000 distributed by the S corporation to Mr. McClary as wages subject to Social Security taxes.

h. In *Glass Blocks Unlimited v. Commissioner*, TCM 2013-180, the Tax Court recharacterized the total distributions made by an S corporation to its president, sole shareholder and only full-time employee, of $30,844 in 2007 and $31,644 in 2008, as wages subject to Social Security taxes.

Citing *Veterinary Surgical Consultants P.C. v. Commissioner*,[18] that an officer who performs more than minor services for a corporation and receives remuneration in any form for those services is considered an employee, and his or her wages are subject to the employer's payment of federal employment taxes. The court went on to find that the taxpayer was the S corporation's only officer, and sole full-time worker in 2007 and 2008 and performed substantially all the work necessary to operate the business.

The Tax Court went on to reject the taxpayer's argument that the distributions constituted repayment of shareholder loans, and the taxpayer's argument that the characterization of all distributions from the S corporation to him as wages constituted unreasonably high compensation to him, citing the multi-factor test used in *Elliotts, Inc. v. Commissioner*.[19] Consequently, the Tax Court found that the total amount of distributions made by the S corporation to its sole shareholder constituted wages subject to Social Security taxes for the years in issue.

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[18] 117 TC 141 (2001), aff'd Sub Nom. Yeagle Drywall Co. v. Commissioner, 54 Fed. Appx. 100 (2nd Cir. 2002).
[19] 716 F.2d 1241 (9th Cir. 1983) *rev* TCM 1980-282.

i. The *Watson* case, the *Herbert* case and the *McClary* case are the first reported decisions 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). The *Watson*, *Herbert*, and *McClary* cases likewise 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***. Consequently, the *Watson*, *Herbert* and McClary decisions represent important victories 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. On the other hand, these cases can be viewed as favorable to taxpayers as they allowed personal service S corporations to distribute some amount of their income ***without*** being subject to Social Security taxes. However, the *Watson* case is somewhat troubling in its rejection of the decision reached in the *Pediatric Surgical Associates*, *P.C*. 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.

j. 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. Commissioner*, 117 TC 14 (2001), *Van Camp and Brennion v. U.S*., 251 F.3d 862 (9th Cir. 2001), *Old Raleigh Realty Corp. v. Commissioner*., 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), *Herbert v. Commissioner*, TC Summ. Op. 2012-124, *Sean McClary Ltd., Inc. v. Commissioner*, TC Summ. Op. 2013-62 and *Glass Blocks Unlimited v. Commissioner*, TCM 2013-180.

k. 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.

l. 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:

(1) Training and experience.

(2) Duties and responsibilities.

(3) Time and effort devoted to the business.

(4) Dividend history.

(5) Payments to non-shareholder employees.

(6) Timing and manner of paying bonuses to key people.

(7) What comparable business pay for similar services.

(8) Compensation agreements.

(9) The use of a formula to determine compensation.

m. Consequently, in non-abusive 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, the Department of Treasury, Congress and the press have issued reports and notices, prepared Bills, and issued commentary 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 over the last 10-15 years to subject S corporation earnings to the self-employment tax. Several of the more recent attempts are discussed below.

1. 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.

2. 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. Proposal is Too Broad and Unfairly Taxes Small Businesses Complying with Law. 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. Proposal is Inconsistent with Long-Standing Policy. 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. Commissioner*, TCM 1990-66, *aff'd without published opinion*, 953 F.2d 639 (4th Cir. 1992), and *Pediatric Surgical Associates, P.C. v. Commissioner*, 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. <u>Provision Would Add Complexity to Tax Law</u>. 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.

3. 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.

4. 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, continues to be a political "hot potato." With the release of Newt Gingrich's tax return, a strong contingent of politicians 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,[20] 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.

5. 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.[21]

6. The "Stop Student Loan Interest Rate Hike Act of 2012" (S. 2343), as originally proposed by Senate Majority Leader Harry Reid, on April 24, 2012, would have required 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 percent of their income from personal services, but is otherwise very similar to the bill proposed by Rep. Pete Stark. Representative Charles Rangel reintroduced the "NEWT" Act on January 22, 2013. The provision imposing self-employment tax on S corporations was ultimately removed from the Act.

7. Recently, a copy of a list of tax breaks which Democrats are targeting for savings as part of the Joint Conference Committee on the Budget was obtained by *Tax Analysts*.[22] The list highlights the so-called "S corp loophole," which the Budget Committee states "is a loophole … that allows certain wealthy professionals to avoid paying payroll taxes on their earnings." The report also refers to the loophole as the "Newt Gingrich/John Edwards" loophole and states that it is "used by owners of S corporations to avoid the 3.9% [sic] Medicare Tax on earnings, which costs taxpayers hundreds of millions of dollars every year." The amount of the tax is actually 3.8% rather than 3.9% as cited in the report.

8. The "Tax Reform Act of 2014" (discussion draft), released on February 26, 2014, by House Ways and Means Chairman, Dave Camp (R-MI) (the "Camp Proposal"), includes a shocking change which imposes the self-employment tax ("SECA") on S corporation shareholders who materially participate in their businesses within the meaning of Section 469. The Camp Proposal generally subjects 70% of the combined compensation and the distributive share of an S corporation's (or partnership's) combined

[20] See, "Shades of John Edwards in Gingrich Return," 2012 TNT 15-2 (1/24/2012).
[21] See "Stark Introduces Bill to Remove Self-Employment 'Tax Dodge'," 2012 TNT 21–37 (1/31/2012).
[22] See "Democrats List Targets for Elimination in Budget Talks," 2013 TNT 217-1 (Nov. 8, 2013).

and distributive share of the entity's income as net earnings from self-employment subject to FICA or SECA, as applicable.

As discussed above, under present law, S corporations are required to pay "reasonable compensation" to their shareholder-employees, which is subject to FICA, but neither the income that passes through to the shareholders (Rev. Rul. 59-221, 1959-1 CB 225) or dividend distributions (Section 1402(a)(2)) made by an S corporation to its shareholders is subject to FICA or SECA (or the new 3.8% tax imposed on net investment income under Section 1411 provided that the S corporation shareholder materially participates in the trade or business conducted by the S corporation). Consequently, under current law, the profits of an S corporation which are distributed to its shareholders as dividends are not subject to FICA or SECA taxes provided that the S corporation is paying reasonable compensation to its shareholder-employees for the services they are actually rendering to the S corporation.[23]

While there certainly is a reasonable argument that different rules in the self-employment tax area should not apply to limited partners versus LLC members versus S corporation shareholders (despite the fact that there any many other provisions of the Code that benefit partnerships and LLCs that don't benefit S corporations and thus are ***not*** applied uniformly among pass-through entities as a whole), the imposition of the self-employment tax on 70% of the total amount of compensation and distributive share of an entity's income is completely arbitrary[24] and not at all consistent with the purpose of FICA and SECA, which is to impose a tax on income derived from personal services actually rendered by an individual.

Well developed law as to what constitutes "reasonable compensation" has provided the IRS with a successful tool for attacking abusive situations and recharacterizing S corporation distributions as wages subject to FICA in appropriate circumstances. Consequently, if any rule is to be applied uniformly to all pass-through entities, it should be the rule currently in effect for S corporations providing that only reasonable compensation paid for services rendered by the owners for services they actually render to the entity should be subject to SECA or FICA.

The authors believe that Representative Camp's proposal would have a crippling effect on many small businesses which utilize pass-through entities (which overwhelmingly outnumber C corporations), and gives no credit whatsoever to the large capital investments many of these pass-

[23] See generally, Looney and Levitt, "Reasonable Compensation Issues for Closely-Held and Service Corporations," 61st NYU Ann. Inst. Fed. Tax'n, 16 (2003).

[24] The Camp Proposal's provision on self-employment income is more onerous than the predecessor provisions proposing to impose self-employment tax on certain small service S corporations. See Looney, "Finding Loopholes in Closing S Corp Loopholes," 2013 TNT 227-12 (November 25, 2013).

through entities, such as those in the manufacturing sector, have made in their businesses. Representative Camp's proposal on this issue is completely arbitrary and totally inequitable to pass-through entities, especially S corporations, which have been formed with increasing frequency by taxpayers to conduct their businesses in reliance upon the rules currently in effect regarding application of SECA and FICA to S corporations and their shareholders.

9. In a report dated July 31, 2014, the "Citizens for Tax Justice" urged adoption of the provision in President Obama's most recent budget plan, which generally imposes the self-employment tax on all businesses providing professional services, whether structured as S corporations, partnerships or LLCs.

H. APPLICATION OF SOCIAL SECURITY TAXES AND NET INVESTMENT INCOME TAX TO S CORPORATIONS

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.[25]

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 (including the NII tax if 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 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

[25] 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.

‘‘avoid’’ these three taxes is abusive or a “loophole” 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.

It is also interesting to note that in a recent study,[26] the study found that S corporation shareholders pay the highest effective tax rate of any type of entity. In particular, the study found that S corporation shareholders pay an effective tax rate of 31.6%, partners of partnerships (which would include limited liability companies taxed as partnerships) pay an effective tax rate of 29.4%, C corporations pay an effective tax rate of 17.8% and that non-farm sole proprietorships pay an effective tax rate of 15.1%. Consequently, it appears that S corporation shareholders are actually paying more than their fair share of taxes, and it would be inherently unfair to impose additional employment taxes on them under the guise of closing a tax loophole. Rather, such a provision would very likely have a substantial negative effect on the economic recovery of America’s small businesses following the Great Recession.

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: 2013-2020, Rev. Fall 2013). 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*, *Howell*, *Riether* and CCA 201436049), 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.

[26] “Report Finds S Corporations Face Highest Effective Tax Rate,” 2013 TNT 153-50 (Aug. 8, 2013). The report is entitled “Entity Choice and Effective Tax Rates,” and was prepared by Quantria Strategies, LLC.

VII. APPLICATION OF NET INVESTMENT INCOME TAX ON GAIN FROM THE DISPOSITION OF INTERESTS IN S CORPORATIONS AND PARTNERSHIPS

A. OVERVIEW

Under Section 1411(c)(4), on the sale of an interest in a partnership or S corporation, the gain from such a disposition is taken into account under Category iii NII (net gain) only to the extent of the net gain that would be so "taken into account by the transferor if all property were sold for fair market value immediately before the disposition of such interest." To be excluded from the definition of net gain, the disposition must be of: (1) property; (2) held in a trade or business; (3) that is active with respect to the taxpayer and is not the trade or business of trading in financial instruments. Therefore, the net gain from the sale or disposition of property held in an active trade or business is not included in the definition of NII (as long as the business is not the business of trading in financial instruments).

Generally, a partnership interest or the stock in an S corporation is ***not*** considered property ***held in the trade or business***. Reg. §1.1411-(4)(d)(i)(B)(1). However, the disposition of stock in an S corporation (or an interest in a partnership) when the taxpayer is considered to materially participate in the business, will avoid the imposition of the 3.8% tax on NII with respect to all activities in which the taxpayer is active. Section 1411(c); Prop. Reg. §1.1411-7.

The Regulations proposed in 2012 governing the disposition of an interest in a partnership or S corporation employed a complicated asset by asset calculation. However, these Regulations were withdrawn and new Proposed Regulations were released in 2013.[27] While the Final Regulations reserve the treatment of sales or

[27] The 2012 Proposed Regulations proposed complex rules governing sales or other dispositions of interests in partnerships and S corporations. The analysis under the 2012 Proposed Regulations began with the gain or loss recognized by the taxpayer on the sale of the interest as being subject to the NIIT and then made adjustments to the gain recognized to take into account amounts that would have been excluded from the NIIT on a hypothetical sale of the partnership's or S corporation's assets. This adjustment required an asset-by-asset valuation of all of the assets held by the partnership or S Corporation. The 2012 Proposed Regulations also seemed to impose the NIIT on a partner or S corporation shareholder receiving a liquidating distribution even though all of the entity's assets had actually been sold as part of the plan of liquidation. The preamble to the Final Regulations addresses these issues as follows:

> Several commentators questioned the proposed regulations' methodology for adjusting a transferor's gain or loss on the disposition of its partnership interest or S corporation stock. These commentators noted that section 1411(c)(4) requires that gain (or loss) from such dispositions be taken into account under section 1411(c)(1)(A)(iii) "only to the extent of the net gain [or loss] which would be taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest." The commentators suggested that section 1411(c)(4) therefore includes gain/loss from the disposition of a partnership interest or S corporation stock only to the extent of the transferor's share of gain/loss from the entity's passive assets. Thus, under the commentator's approach, the amount of gain or

other dispositions of interests in partnerships and S corporations, the 2013 Proposed Regulations establish an entirely new regime which would essentially impose the NIIT on the lesser of the gain recognized on the sale of the entity interest by the partner or the shareholder or the gain that would have been subject to the NIIT if all of the entity's assets had been sold under rules established under the 2013 Proposed Regulations using an activity by activity test.

B. LIQUIDATION

If in a (1) fully taxable disposition of the entity's assets, there is a (i) liquidation of the partnership or S corporation as part of (ii) the overall plan, then the (2) transaction is treated as an asset sale by the entity for purposes of Section 1411 and no additional NIIT is triggered as a result of the liquidating distribution to the partner or shareholder if the partner or shareholder (i) materially participated in the activities of the entity and (ii) the entity was not in the trade or business of trading in financial instruments. Similar treatment is afforded to an S corporation under Section 336(e) or Section 338(h)(10). Prop. Reg. §1.1411-7(a)(4).

C. CALCULATION

Upon the transfer of an interest in a partnership or S Corporation, included as NII under Category (iii) is the lesser of: (1) the amount of gain on the disposition of the interest as determined in accordance with Chapter 1; or (2) the transferor's allocable share of Chapter 1 net gain from the deemed sale of assets held in a passive trade or business as determined under Temp. Reg. §1.469-2T(e)(3), allocating a ratable portion to each activity and netting any losses from the disposition of passive activities against gain from passive activities.[28]

D. ACTIVITY BY ACTIVITY TEST

In recognition of the fact that the rules of Section 469 and its underlying regulations would require the computation of gain or loss on an activity-by-activity basis, Prop. Reg. §1.1411-7 eliminates the asset-by-asset approach on the deemed sale by the entity and imposes an activity-by-activity test instead. Prop. Reg. §1.1411-7(b) provides an example of the calculation using the activity by activity test.

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loss included in section 1411(c)(A)(iii) is the lesser of a taxpayer's gain on the disposition of the interest or the taxpayer's share of gain or loss on the deemed sale of the entity's assets that would be included in calculating the taxpayer's net investment income. Commentators also discussed the complexity of the proposed regulations, stating that the regulations imposed a high compliance burden, including requiring a transferor to obtain information from the entity regarding valuation and tax basis.

[28] Prop. Reg. §1.1411-7(b)(1)(i)(B) provides the recharacterization of passive income into non-passive income in Temp. Reg. §1.469-2T(e)(3)(iii) does not apply.

Example. Assume that T owns a one-half interest Partnership. T sells the interest in Partnership for $1,000,000. T's basis in the interest was $550,000. Partnership was engaged in three activities, X, Y, and Z. T was active in activity Z, but activities X and Y were passive with respect to T. To calculate the amount of net gain included as Category (iii) income for T, examine the gain or loss on each activity.

Activity	**Adjusted Basis**	FMV	**Gain/Loss**	**T's Gain/Loss**
X (passive to T)	$800,000	$600,000	($200,000)	($100,000)
Y (passive to T)	$100,000	$700,000	$600,000	$300,000
Z (active to T)	$200,000	$700,000	$500,000	$250,000
Total				$450,000

The amount of gain or loss T would recognize under Temp. Reg. §1.469-2T(e)(3) is $200,000 (($100,000) from X + $300,000 from Y). The amount of gain recognized under chapter 1 as a result of the disposition is $450,000. Thus, T includes $200,000 as Category (iii) income for purposes of Section 1411 (the lesser of the gain from the disposition of the partnership interest or the partners' allocable share of the net gain from the deemed sale of the assets of each activity determined in accordance with Temp. Reg. §1.469-2T(e)(3)). Prop. Reg. §1.1411-7(b)(ex. 1).

E. OPTIONAL SIMPLIFIED REPORTING METHOD

Under certain conditions, taxpayers will be allowed to use a so called optional simplified reporting method that eliminates the need to apply valuations of the entity on an activity-by-activity basis. The simplified regulatory method looks at historical data relating to the allocations to the selling partner or shareholder over the testing period (generally the current year of sale of the interest and the prior two tax years) and determine how much NIIT should be attributable to the sale of the interest. This optional rule only applies if either (1) the allocable NIIT items over the test period were 5% or less of the total allocations over that period to the partner or shareholder and the gain recognized by the partner or shareholder on the sale was $5 Million or less, or (2) the gain recognized by the seller does not exceed $250,000.

F. QSSTs

The preamble to the 2012 Proposed Regulations requested comments on whether special coordination rules are needed to address dispositions of S Corporation stock held by a Qualified Subchapter S Trust (QSST). This is relevant because the income beneficiary of a QSST is treated as the Section 678 owner with respect to the S Corporation shares held by the QSST, and because upon a disposition of such S Shares by the QSST the trust is instead treated as the owner in determining the tax consequences of the sale. However, Section 1361(d)(1)(c) and Reg.

§1.1361-1(j)(8) provide that for purposes of Section 465 and Section 469, the disposition of the stock is treated as made by the income beneficiary.[29] The 2013 Preamble stated that the 2013 Proposed Regulations opted to not provide specific examples of the operation of the disposition of an interest in an S corporation owned by a QSST. Instead, the Preamble stated that the existing income tax rules in Section 1361 and Section 469 are sufficient.

Generally, the income beneficiary of a QSST is treated as the shareholder of the S corporation for income tax purposes. Section 1361(d). Therefore, as the taxpayer, material participation is generally determined by reference to the beneficiaries' activities and the imposition of the 3.8% tax would be determined by examining the beneficiary's participation in activities of the S corporation. I.R.B. 2013-51 at 784. However, Section 1.1361-1(j)(8) states that upon the disposition of stock in an S corporation by a QSST, the trust rather than the income beneficiary is treated as the owner of the S corporation stock for income tax purposes.

The 2013 Proposed Regulations provide that in the case of a QSST, the application of Section 1411(c)(4) (concerning dispositions of active interests in subchapter S corporations) is made at the trust level, consistent with the Chapter 1 treatment of the QSST under Reg. §1.1361-1(j)(8)). Although the Proposed Regulations do not expressly state that material participation is determined at the QSST level, the Preamble indicated that the material participation analysis will occur at the trust level as well.[30]

When a QSST disposes of stock in a transaction that is deemed an asset sale, the IRS has previously ruled that the income tax consequences are ***applied at the trust level, not the beneficiary level*** because this would be consistent with Section 1.1361-1(j)(8). *See* PLR 2012232003 (Aug. 10, 2012). In the case of the disposition of stock from a QSST with a Section 336(e) or Section 338(h)(10) election in place, then the application of Section 1411 will occur at the trust level.

VIII. APPLICATION OF NET INVESTMENT INCOME TAX TO ESTATES AND TRUSTS

A. OVERVIEW

Reg. §1.1411-3 contains the rules for trusts and estates, including the types of trusts to which the tax applies, i.e., ordinary trusts, as described in Reg. §301.7701-4(a). Reg. §1.1411-3(a)(1)(i). The NII tax does not apply to business

[29] Because of this inconsistent treatment, the QSST beneficiary, for Chapter 1 purposes, does not have any §469 gain from the disposition, resulting in the beneficiary's suspended loss under §469 remaining. Accordingly, that loss will then be considered a loss from a non-passive activity. This leaves open the question of whether the beneficiary's status under Section 469 with respect to the S Corporation is attributed to the trust.

[30] "[T]he treatment of a stock sale as passive or nonpassive income is determined under section 469, *which involves the issue of whether there is material participation by the trust*." I.R.B. 2013-51 at 784 (emphasis added). See VIII.A.1 *infra* for a discussion of material participation and trusts.

trusts under Reg. §301.770-14(b), certain state law trusts, pooled income funds, cemetery perpetual care funds, qualified funeral trusts, etc., as well as tax-exempt trusts, excluding even unrelated business taxable income of those trusts. Reg. §1.1411-3(b)(1).

1. **Trusts Subject to Tax**. Under Subchapter J, U.S. domestic estates and nongrantor "ordinary" trusts, in order to appropriately allocate the incidence of income tax between an estate or trust and its beneficiaries, are allowed a deduction for distributions made to beneficiaries in computing taxable income at the estate or trust level. The amount deducted in computing the taxable income of the estate or trust is included in the computation of the taxable income of the beneficiaries. The character of the income earned at the estate or trust level is preserved at the beneficiary level for U.S. beneficiaries of domestic trusts. Similarly, in the case of the Section 1411 tax, the tax applies to the "undistributed net investment income" of the trust. The undistributed net investment income is defined as net investment income reduced by (i) the share of net investment income included in the beneficiary distribution deduction of the estate or trust, and (ii) the charitable deduction for amounts paid or permanently set aside for charitable purposes. Thus, an estate or trust is treated as a conduit of net investment income to the beneficiary and it is only that portion of net investment income that is retained at the estate or trust level that is treated as undistributed net investment income and taxed to the estate or trust. Items of income characterized as NII and currently distributed to beneficiaries as DNI would retain the character of NII for purposes of determining the NII tax liability of the beneficiaries.

For an estate or trust to be subject to the NII tax, the estate or trust must have (i) ***undistributed net investment income*** and (ii) adjusted gross income over the dollar amount at which the highest tax bracket for an estate or trust begins for the tax year. For 2014, this amount is $12,150.[31] Because the threshold amount for a trust or estate is significantly lower than for individuals, there is certainly a tax incentive to distribute net investment income to the beneficiaries.[32] Conversely, there may be significant non-tax reasons to retain the income in the trust despite the tax consequences, for instance to incentivize the beneficiary.

Thus, in addition to keeping record of trust accounting income and distributable net income, trustees must keep records of net investment income accumulated by a trust and net investment income distributed to a beneficiary, taking the character of the income into account.

a. Example of Undistributed Net Investment Income.

[31] Only income in the trust that was created in 2013 or later will be treated as net investment income.
[32] The threshold amount for married taxpayers is $250,000 and $200,000 for other taxpayers.

(i) Assume that in 2014 Trust receives income from dividends and interest in the amount of $1,000,000, all of which is net investment income under Category (i). The sole beneficiary is an unmarried individual who has no income outside of distributions from Trust. If the Trustee does not distribute any of the $1,000,000 of income, Trust will owe approximately $37,538.30 of tax under Section 1411 tax (3.8% multiplied by the lesser of undistributed NII of $1,000,000 or the difference between Trust's adjusted gross income of $1,000,000 and $12,150).

(ii) Assume the same facts as above except that the Trustee distributes $199,000 to the sole beneficiary of Trust. Trust is left with $801,000 of undistributed net investment income. Trust will owe approximately $29,976.30 of tax under Section 1411 tax (3.8% multiplied by the lesser of undistributed NII of $801,000 or the difference between Trust's adjusted gross income of $801,000 and $12,150).

2. **<u>Grantor Trusts</u>**. In the case of a grantor trust treated as owned by the grantor or another person for income tax purposes under Sections 671–679 (a "grantor trust"), the Section 1411 tax will not apply to the trust itself. Rather, the income of the trust will be treated as being the income of the grantor or other owner for purposes of the Section 1411 tax. Furthermore, the activities of the grantor, not the trustee, are used to determine material participation for measuring whether the income is passive or active.

a. <u>Powers That Cause Grantor Trust Status</u>. Specific powers in a trust document will make the trust a grantor trust for income tax purposes. Some of the more common powers include:

(i) The power to "reacquire the trust corpus by substituting other property of an equivalent value;" Section 675(4)(C).

(ii) If a related or subordinate trustee (to the grantor) has the power to spray income and principal to various beneficiaries; Section 674.

(iii) The power of the trustee to allow the grantor to borrow money without adequate interest; Section 675(2).

(iv) An independent trustee has the power to make the grantor's spouse a discretionary beneficiary when the trustee may spray income or principal to the spouse.

3. **<u>QSSTs</u>**. As discussed in § VIII. F. *supra*, a QSST beneficiary is generally treated as the owner of the income of a QSST for income tax purposes. Therefore, the activities of the QSST beneficiary will generally determine whether the income is active or passive. However, the trustee, not the beneficiary will be the relevant participant upon the disposition of the S corporation stock by a QSST. The Proposed Regulations indicate that the activities of the trustee, not the QSST beneficiary are relevant for purposes of Section 1411.

4. **<u>Charitable Purpose Trusts/Estates</u>**. The Final Regulations take the statutory description of trusts that are excepted from the Section 1411 tax (a trust "all of the unexpired interests in which are devoted to one or more of the purposes described in Section 170(c)(2)(B)") and extended it to also apply to estates that are included in that description. These "charitable purpose estates" are exempt from Section 1411. See Reg. §1.1411-3(b)(1)(i).

5. **<u>Electing Small Business Trusts (ESBTs)</u>**. The Final Regulations continue to treat an ESBT as two separate trusts for computational purposes but these separate parts are consolidated into a single trust for purposes of determining the AGI threshold under Section 1411(a)(2)(B)(ii). When a ESBT disposes of its S Corporation stock, the Final Regulations make it clear that the installment method is applicable for Section 1411 purposes.

6. **<u>Charitable Remainder Trusts (CRTs)</u>**. The 2012 Proposed Regulations had adopted a special computational rule for classifying CRT income and distributions for purposes of Section 1411. The Final Regulations provide that NII is categorized and distributed based on the existing §664 "category and class" system. Reg. §1.1411-3(d)(2). The Final Regulations retain the concept (found in the 2012 Proposed Regulations) of "accumulated net investment income" (ANII), which is defined as the total amount of NII received by a CRT for all tax years beginning after 2012, less the total amount distributed in all prior years beginning after 2012. The Final Regulations apply the Section 664 "category and class system" to ANII by providing that the Federal income tax rate applicable to an item of ANII, for purposes of allocating that item of ANII to the appropriate class within a category of income, is the sum of the income tax rate imposed under Chapter 1 and the tax rate under Section 1411. *See* Reg, §1.1411-3(d)(2).

7. **<u>Foreign Trusts and Estates</u>**. While Section 1411 does not address foreign estates and trusts, the Final Regulations reconfirm the rule that Section 1411 is inapplicable to foreign estates, but clarified that U.S. beneficiaries of such foreign estates are subject to Section 1411 with respect to distributions they receive from such trusts. ***See*** Reg. §§1.1411-3(e)(ii) and §1.1411-4(e)(1).

B. NET INVESTMENT INCOME

1. **Calculation**. The starting point in computing net investment income for an estate or trust is the same as for individuals. NII is the excess (if any) of the sum of:

- gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business,

- other gross income from trades or businesses to which the tax applies (passive income or securities/commodities trading income), and

- net gain (to the extent taken into account in computing taxable income) from the disposition of property other than property held in a trade or business to which the tax does not apply,

less allowable deductions properly allocable to such gross income or net gain under Section §651 or Section 661, and the share of NII allocated to the Section 642(c) deduction of the estate or trust in accordance with Reg. §1.642(c)-2(b) and the allocation and ordering rules under Reg. §1.662(b)-2.

2. **Material Participation of Trusts**.

a. Overview of Existing Law.

(i) For non-grantor trusts, the activities of the trustee are relevant for determining material participation. S. Rept. No. 99-313, at 735 (1986), 1986-3 C.B. (Vol.3) 1, 735.[33] The Preamble to the Final Regulations states that material participation is determined in accordance with the principles of Section 469. Although there are quantitative tests for determining the material participation of individuals, the Section 469 regulations for determining the material participation of trusts are reserved and thus there are no corresponding quantitative tests to determine material participation for trusts. The trustee must materially participate in the activities of a business held in trust on a regular, continuous, and substantial basis." Therefore, a bright line test does not exist for determining material participation of a trust.

(ii) The IRS takes the position that only a trustee's activities as a fiduciary count towards measuring material participation of the trust, even if the trustee simultaneously works as an

[33] *But see* Mattie Carter Trust v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

employee in a business held in trust. *See e.g.* TAM 201317010 (Apr. 26, 2013); PLR 201029014 (Jul. 23, 2010).

(iii) That position was first rejected by a federal court in 2003 when a ranch business was conducted through a trust. *Mattie Carter Trust v. United States,* 256 F. Supp. 2d 536 (N.D. Tex. 2003) (holding that when a trust directly runs a business the activity of the trust's employees, if regular, continuous, and substantial, can satisfy the material participation test and rejecting as irrelevant the legislative history cited by the Service). The court analogized the trust to a closely held corporation. The IRS did not appeal because the trustee was also materially participating in the ranching activities of the trust. The IRS continued to maintain its position in TAM 201317010 and PLR 201029014 that only the activities of the trustee will count towards determining material participation.

(iv) The more likely scenario causing issues for taxpayers is what activities of the trustee of a non-grantor trust count towards material participation, when the trust merely owns the underlying business interest (as opposed to running the business as was the situation in *Mattie Carter*). The Tax Court faced this very issue in *Frank Aragona Trust v. Commissioner*, 142 TC No. 9 (Mar. 27, 2014). The tax court first noted that the determination of material participation relative to a business interest held in by a non-grantor trust is determined in accordance with the activities of the trustee. The trustee materially participated in the activities of the business in a non-fiduciary capacity. The Tax Court held that held that a trustee's non-fiduciary activities—the trustee's activities as an employee—count towards determining the material participation of the trust.[34] Under the *Frank Aragona* analysis, if the trustee of a non-grantor trust actively participates in a business held by the trust, then the trust will be considered to materially participate in the business.

b. <u>Comments on Material Participation of Trusts from AICPA</u>.[35]

(i) The Preamble to the Final Regulations welcomed comments regarding the material participation of trusts and estates. On September 22, 2014, the AICPA submitted

[34] To date, the IRS has not announced whether it will non-acquiesce to the decision in *Frank Aragona*.
[35] The Comments are attached in their entirety as Appendix A.

comments as requested by the Preamble (the "Comments"). The Comments recognized Reg. §1.469-5T(g), governing the material participation of trusts and estates, has been reserved for almost 30 years and to date guidance has not been issued regarding the material participation of trusts and estates.

(ii) The AICPA's Comments generally followed the existing analysis of practitioners. However, in some cases, the Comments go beyond the framework of the current analysis and ask for specialized rules.

(a) Whose Participation is Relevant?

(1) Grantor Trusts. The grantor or deemed owner is the suggested relevant participant.

(2) Non-grantor Trusts

i) The Comments recommend that the Regulations incorporate rules following *Mattie Carter* and *Frank Aragona*. For example, the AICPA specifically requested that the determination of material participation of a trustee include activities in both a fiduciary and non-fiduciary capacity. Further, the AICPA Comments suggest that it should be immaterial whether the Trustee is also an owner of the business.

ii) The Comments request that the activities of agents or employees of a business held in a trust or estate count towards measuring material participation, as long as the agent or employee's activities are directly related to the activity and are "regular, continuous, and substantial."

(b) <u>Measuring Activities for Material Participation</u>.

(1) The Comments suggest that the overall standard should remain "regular, continuous, and substantial."

(2) Further, the Comments request that the first six quantitative tests in Reg. §1.469-5T(a) that apply to individuals also be available to estates and trusts.

(iii) The AICPA's Comments also asked for Regulations that provide specialized rules outside of the scope of the current analysis.

(a) The Comments request a rule that provides a grace period for an estate or former grantor trust in which the deemed owner materially participated to allow material participation to continue for a certain time period after the business becomes part of an estate or a trust's grantor trust status is terminated.

(b) Contrary to current analysis as discussed in § VII.F. *supra*, the Comments request a rule that provides the beneficiary, not the Trustee is the relevant participant when determining material participation upon the sale of stock held in a QSST.

(c) The Comments suggest a rule that provides that the S portion and the non-S portion of an ESBT be treated as a single trust for purposes of measuring material participation.