ROBERTS & HOLLAND LLP

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Recent Developments Relating to S Corporations

By: Elliot Pisem and David E. Kahen

We briefly discuss below two recent Tax Court memorandum decisions relating to S corporations (that is, a corporation with respect to which an election has been made for pass-through tax treatment under subchapter S of Chapter 1 of the Internal Revenue Code), and a recent change in IRS policy regarding private letter rulings on common S corporation issues. In each of the Tax Court decisions, the individual taxpayer was seeking a result that, at least on the facts set forth, might have been achievable with proper documentation indicating respect for and maintenance of the corporate entity, but the government nonetheless prevailed in sustaining the tax deficiencies at issue.

Brown v. Commissioner

In *Brown* (TC Memo 2017-18), two individuals (husband and wife, and hereinafter "Brown") owned all of the stock of a corporation incorporated in 1996 ("INC") and all of the membership interest in a limited liability company ("LLC"). Each of the entities had elected to be an S corporation. The husband was involved in the telecommunications industry.

INC failed to satisfy payroll tax obligations in the years 2000 through 2002, and was administratively dissolved by Arizona (for failure to file an annual report) in 2007. The IRS made efforts to collect the unpaid payroll taxes from INC, and from the shareholders of INC on the basis that they had a duty (as officers or otherwise) to cause INC to pay to the government payroll taxes required to be withheld from its employees. The IRS determined that the shareholders were responsible for a penalty (sometimes referred to as the "trust fund recovery penalty" or "TFRP") equal to 100% of the unpaid tax amount as imposed by IRC sections 6671 and 6672(a).

During 2012, and at a time when Brown owed a TFRP of at least $180,911, Brown transferred $215,000 from an account of LLC to their attorney and the attorney sent a check for that same amount to the IRS. The letter referenced INC by name and employer identification number and the TFRP amounts due in respect of INC for various calendar quarters, and directed that the payment be applied to (i) the employee withholding amounts with respect to which the TFRP was imposed and (ii) any accrued but unpaid interest attributable to the late payment of taxes with respect to which the TFRP was imposed. The letter stated that the enclosed amount could *not* be applied to any amounts *other than* those for which the shareholders had been determined to be liable under TFRP procedures.

Although no income tax return had been filed by INC for the years 2003 through 2011, INC filed a Form 1120S, marked as a final return, for 2012. The return indicated that the corporation had no assets, and no income for the year, but claimed a deduction of $180,911 for salaries and wages. Schedule K-1's were issued to the shareholders reporting ordinary losses of $180,911 in the aggregate, which losses Brown asserted were attributable to wage expenses not deducted by INC in any earlier year. The IRS disallowed that deduction and made other adjustments to the tax returns of Brown. The sole issue before the Tax Court was whether the $180,911 expenditure resulted in a loss or other deduction allowable to Brown.

Brown's argument was relatively straightforward. Income and employment tax amounts that are required to be withhold from employees' wages, and paid over to tax authorities on the employees' behalf, are generally deductible as salary expense as if paid directly to the employees. INC, a cash method taxpayer, had not deducted those withholding liabilities when they arose, apparently because they were not paid at that time. Since those withholding liabilities of INC were satisfied in 2012, a deduction should be allowed in 2012.

Brown further argued, somewhat audaciously, that the circumstance that the liabilities were paid in 2012, and that a corporate return was filed for that year, established that INC continued to exist and to carry on a trade or business in that year (such that the payment could be de-

***Elliot Pisem** and **David E. Kahen** are partners in the law firm of Roberts & Holland LLP.*

ducted by INC as a trade or business expense in that year), notwithstanding that INC was dissolved under local law several years earlier and had no assets or other business activity in that year.

The IRS contested some of the facts alleged by Brown. The court found, however, that the facts and exhibits stipulated by the parties were sufficient to reach a conclusion (without trial) upholding the disallowance of the deduction. The court concluded that INC was no longer engaged in any trade or business in 2012, and that it had been dissolved under local law. The decision noted that, even after dissolution, a corporation may retain assets in the process of its liquidation, and as a result remain a taxable entity. However, there was no evidence that INC retained any assets. Therefore, the deduction could not be claimed by INC in 2012 because it no longer existed.

As further support for the denial of the deduction, the court found that INC could not claim the deduction because it did not actually pay that amount. The court noted the flow of funds from LLC to the attorney to the IRS, and construed the attorney's letter accompanying the check as indicating that the payment was made on behalf of the shareholders of INC rather than INC itself.

Finally, the court observed that the payment of a TFRP could not be claimed as a deduction by the shareholders on whom the penalty was imposed because such a deduction is barred by IRC section 162(f), which provides that no amount otherwise deductible as a trade or business expense under section 162(a) will be allowed as a deduction "for any fine or similar penalty paid to a government" for the violation of a law.

Whether the amount could nonetheless, under principles of *Arrowsmith v. Commissioner* (344 U.S. 900 (1952)), have been allowable as a non-business capital loss incurred in connection with a transaction entered into for profit (that is, the disposition of the stock of INC), was not discussed, but that argument might not have met with any greater success, taking into account public policy limitations on deductions under IRC section 165 that are similar in scope to section 162(f)) (see *Duncan v. Commissioner*, 68 F.3d 315 (9th Cir. 1995)).

If INC had continued in existence with a bank account, funds had been contributed by the shareholders to INC, and then a payment made from INC's bank account to the IRS for the withholding taxes, the result on the deduction issue might have been different; and the TFRP, essentially a collection mechanism for withholding taxes, might then have been abated (see IRM 1.2.14.1.3 (6/19/2003), Policy Statement 5-14). However, there may have been other reasons why such a form of resolution would not have been desirable.

Fleischer v. Commissioner

In *Fleischer* (TC Memo 2016-238), the individual petitioner ("Fleischer") formed a corporation, Fleischer Wealth Plan (FWP); caused it to elect to be an S corporation; and became its sole shareholder. FWP paid Fleischer an annual salary pursuant to an employment agreement which contemplated that he would work for FWP as a Financial Advisor.

However, the income from Fleischer's financial consultant business for the years at issue (2009-2011) was attributable to payments received under (i) a representative agreement that he entered into with a financial services company and (ii) a broker contract that he entered into with an insurance company—in each case in his personal capacity and with no reference to FWP.

The financial services company and the insurance company each reported payments made under the relevant agreement on a Form 1099 issued to Fleischer. He caused those amounts to be reflected on the returns filed by FWP, however, and filed his personal returns in a manner indicating, for purposes of the self-employment tax, either that he was not engaged in any trade or business other than through the S corporation, or that any business be conducted personally did not result in net earnings from self-employment.

The IRS asserted self-employment tax deficiencies, on the rationale that the revenue from the financial consulting business was earned by Fleischer and therefore must be taxed directly to him. The court agreed, on the basis that FWP had no contractual relationship with anyone other than its shareholder and that the revenue was attributable to contracts between third parties and Fleischer in his personal capacity. Fleischer's assertion that the representative and broker contracts were entered into by him personally because he had various registrations needed for the purchase and sale of securities that would have cost "millions and millions of dollars" (per his testimony) to obtain in FWP's name, did not, per the decision, "allow petitioner to assign the income he earned in his personal capacity to FWP."

Changes to IRS Ruling Policy

IRS revenue procedures relating to the issuance of private letter rulings provide that the IRS will not ordinarily issue a ruling "with respect to an issue that is clearly and adequately addressed by statute, regulations, decision of a court, revenue rulings, revenue procedures, notices, or other authority published in the Internal Revenue Bulletin" – that is, a so-called "comfort ruling" (see, e.g., Rev. Proc. 2017-3, §4.02(9)).

Brad Poston, a senior counsel of the IRS Office of Chief Counsel (Passthroughs and Special Industries), stated in an interview on December 23, 2016, that the IRS will no longer rule on issues such as whether an S election remains in effect where: the S corporation election form was missing information; certain shareholders filed inconsistently with the S election; or unplanned disproportionate distributions were made to shareholders (see Daily Tax Report (BNA), December 27, 2016, at G-5). Apparently such rulings were being requested with increasing frequency in the context of acquisitions of S corporations, and the change in policy was attributed at least in part to declining resources within the IRS and also to a view that at least some of the rulings were comfort rulings or did little more than recite rules already set forth in regulations.