



November 3, 2005 Podcast
Substance over Form—Who Can Assert It and When?



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This week we consider three cases where the issue of “substance over form” are discussed by the courts. In one case we look at an unsuccessful attempt by the taxpayer to assert the position, and then compare that with the successful assertion of this position in two cases by the IRS.

Assignment of Income to S Corporation Not Valid—Self Employment Tax Assessed

(Arnold v. Commissioner, T.C. Memo. 2005-256, 10/31/05) The Tax Court ruled that a husband and wife did not show that their income for services that they had reported on separate S corporation returns was truly the corporation’s income and held the taxpayers were liable for self-employment tax on the amounts received.¹

Mr. Arnold was an accountant² and Mrs. Arnold was a real estate agent. They each formed an S corporation and assigned their service income to those corporations. The corporations did not pay the taxpayers a salary during the years in question. Amounts distributed to the Arnolds were treated as loans, and they executed promissory notes for the balance due at the end of each year. No payroll taxes were paid on any of these amounts.

Mr. Arnold personally contracted with employees and independent contractors for services, and then leased those services to his S corporation. He charged his corporation 25% more

- ¹ The case also covered a number of other issues related to a failed S election by another corporation of the taxpayers.
- ² The court notes that Mr. Arnold was suspended from practice before the Internal Revenue Service in 1991.

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than he paid these service providers, which amounted to \$17,995. He then deducted various expenses he claimed were related to this leased payroll operation. The operation was treated as a rental activity, and Mr. Arnold took the position that the income was not self-employment income.

Mrs. Arnold was a real estate agent under contract to a real estate brokerage. Checks from the brokerage were paid directly to Mrs. Arnold in her name. When she signed her Form W-9 to the agency in 1999, she noted on the bottom of the form “Please do not issue a 1099 for me.”

The court unwound the whole process, treating all income as service income personally earned by the Arnolds and subject to self-employment tax.

The court noted that for the income for services to be properly taxable to the corporation, the taxpayers had to show

- They were employees of the corporation in question that received the income from the services they performed **and**
- A contract or similar agreement exists between the corporation and the person or entity using the services that recognizes the corporations’ right to direct or control the work of the service provider.

While the court held the Arnolds were employees of their S corporation due to being officers of the corporation (per IRC §3121(d)(1)), they did not show that the customers had any sort of contract or agreement with the corporation.

This case appears to represent a complex attempt to work around the cases involving S corporations and self-employment taxes, trying to make an end run around the IRS by technically avoiding distributions that could be treated as wages and instead issuing notes. The court avoided having to worry about whether valid loans existed by simply noting that there was no evidence that this income was the income of the corporation to begin with.

This case does show that taxpayers need to have their customers recognize the corporation as the service provider if they are going to attempt to incorporate a service business. In some cases, due to regulatory issues or simply the fact that the payor wanting to have a personal contract with the individual, it may not be possible to get recognition of the corporation’s right to control the service provider.

As well, the case illustrates the difficulties taxpayers face when they, rather than the IRS, attempts to argue substance over form—that is, despite the fact that the contract was with the individual and payments were made out that way by the customer, the reality of the transaction was something else. The IRS will be more likely to prevail when they attempt such a reclassification simply because the government was not a party to the transaction and had no input on the form of the transaction. However, the taxpayer did have just

such an option to influence the form of the transaction.

Partnership Found Not to Be Owner of Real Estate, Entire Value Taxable to Estate

(Estate of Marie A. Maniglia v. Commissioner, TC Memorandum 2005-247, 10/26/05) The estate failed to show that a piece of real estate that was titled in the name of the taxpayer's trust was actually the property of a partnership between the trust and the decedent's son, and therefore the entire value of the real estate parcel was includable in the decedent's estate. The fact that partnership returns had been filed from 1978 through 1999 and that the son managed the property were not enough to overcome the fact that all of the formalities indicated that the trust was the sole owner of the property.

A taxpayer has an uphill fight arguing that substance should prevail over form when the taxpayer was able to control the form of the transactions in question, and the court found the evidence that was presented was far from persuasive. The court was especially unimpressed with the accountant who testified, commenting that the accountant could not remember when he had been licensed as a CPA, how long he had been preparing the returns for the individuals involved, and admitted in his testimony that his license had been suspended in the past due to a tax evasion conviction.

Payments Received from Supplier Treated as Income and Not a Loan

(Karns Prime & Fancy Food, Ltd. v. Commissioner, TC Memorandum 2005-233, 10/5/05) The Tax Court held that \$1.5 million received from the taxpayer's supplier was an advance payment of rebates that was currently taxable, and not a loan, despite the fact that the taxpayer had signed a note. The court noted that payments under the note would only actually become due if the taxpayer defaulted on its obligation to purchase a minimum amount of product from the supplier, and that the supplier and taxpayer expected that the minimum purchase obligations would be met.

The court distinguished the case from the situations decided in *Erickson Post Acquisition, Inc. v. Commissioner*, TC Memorandum 2003-218 and *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, where certain payments were held to be true liabilities and not recognized currently as income.

Other Matters

Noncorporate Taxpayers to Have Single Sixth Month Extension of Time to File

(TD9229, 11/07/05) The IRS quietly announced during the year by releasing the draft of the 2006 Form 4868, Application for Automatic Extension of Time to File An Individual Income Tax Return, that for 2006 there will be single six-month automatic extension request rather than the four-month automatic extension request

followed by a two-month request for discretionary extension as in previous years (Form 2688). On November 7 the IRS made this official and announce that other noncorporate taxpayers would apply for a single automatic extension of time to file.

Individuals will request a six month extension of time to file using Form 4868, the form used through this year to obtain an automatic four month extension of time to file. Form 7004 will be modified to be used by a much expanded list of entities rather than being a corporation extension form only. Taxpayer that previously filed Form 2758 (extension of time to file certain excise, income, information and other returns) and Form 8736 and 8800 (partnerships, real estate mortgage investment conduits (REMICs) and certain trusts) will now file the modified Form 7004 to obtain an automatic six month extension of time to file returns. Forms 2688, 2758, 8736 and 8800 have been obsoleted by these regulations.

The temporary regulations are effective for applications for an automatic extension of time to file certain returns filed after December 31, 2005. That means they apply to 2005 returns *and* any 2004 returns with an original due date after December 31, 2005. 2004 fiscal year filers who have due dates after December 31 should continue to file the old forms to request an extension of time, but the IRS will grant a six month extension of time to file the return if the request would otherwise qualify under the regulations except for the use of the specified form.

The stand-alone form to request a six month extension of time to file a gift tax return (Form 8892) is modified to remove the requirement to give an explanation of the need for the extension and no signature will be required. Remember that taxpayers who have an extension of time to file their individual income tax return are deemed to already have an extension of time to file their gift tax return, so those taxpayers do not need to file the Form 8892.

IRS Continues Battle on Communications Excise Tax and Suffers More Losses

(American Bankers Insurance Group, CA11, 408 F.3d 1328, 5/10/05; Notice 2005-79, 10/20/05; OfficeMax, Inc., CA6, 2005-2 USTC ¶70,246, 11/2/05) The IRS lost on appeal in the Eleventh Circuit Court of Appeals on the issue of whether the excise tax on whether the excise tax under §4252 applies to “toll telephone charges” that are based on time but not on distance. The issue is how this provision in the definition should be read, specifically the word “and” shown italics below:

4252(b) TOLL TELEPHONE SERVICE. --For purposes of this subchapter, the term "toll telephone service" means --

(1) a telephonic quality communication for which (A) there is a toll charge which varies in amount with the distance *and* elapsed transmission time of each individual communication and (B) the charge is paid within the United States...

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The government estimates that \$9 billion in refunds claims may be required if this tax is found not to apply to the transactions in question. The IRS insists that the phrase defines two types of charge schemes—that is a tax is imposed on charges that vary in the amount of distance and on charges that vary with the amount of time, rather than only applying to charges that vary based on both items. However, the Eleventh Circuit rejected that position, essentially holding that the IRS was attempting to convert an “and” into an “or” in the statute.

On October 20, 2005 the IRS warned that taxpayers must continue to pay the tax to “collecting agents” (the entities providing the communications service) and that claims for refund would not be processed—including those that would be subject to Eleventh Circuit jurisdiction on appeal. The IRS justified this position by noting they were pursuing separate appeals in five separate circuits and specifically noted that the in *OfficeMax* case in the Sixth Circuit they were awaiting a decision.

The IRS now has their answer from the Sixth Circuit, and it’s not one they will be happy with. The Sixth Circuit majority found as the Eleventh Circuit did on this issue, awarding OfficeMax a refund of the tax they had paid. The court specifically rejected the IRS’s position that it should grant deference to Revenue Ruling 79-404 (which expanded the tax to cover ship to shore communications, even though admitting the communication not meet the literal requirements of the statute because it did not vary with distance) in interpreting this statute, noting:

Generated by an agency that frequently insists that its citizens “turn square corners,” *Rock Island, Ark. & Lou R.R. Co. v. United States*, 254 U.S. 141, 143 (1920), this revenue ruling no more supports an “essential” method of tax imposition than it does an “essential” method of tax payment. As other parts of our opinion explain, neither the legislative history nor one-sided generalizations about the purpose of the law make the case for straying from the ordinary meaning of the language in the statute. Agencies in the end receive *Skidmore* respect because of the persuasiveness of their reasoning, not in spite of it.

It remains to be seen whether the IRS will now give up on this matter, or whether they will continue to demand collection and payment of the tax, even in the Eleventh and, now, Sixth Circuits as they continue to look for a win on this issue in another circuit or decide to attempt to get the Supreme Court involved.