Edwards's S Corp.: The Beat Goes On

To the Editor:

While Tom Daley (*Tax Notes*, Sept. 27, 2004, p. 1577) is probably correct in his assessment that most readers left for dead the beating of Sen. John Edwards's Medicare tax ''planning'' (the charitable way of looking at the issue) some time ago, he invites further discussion — if not with regard to the situational comments in his letter, then in response to his query how (paraphrasing) ''other accountants out there'' would approach a situation (which ostensibly arises from Edwards's treatment of the issue).[1]

Specifically, Mr. Daley says, ''I am only asking how other accountants out there would approach a situation in which a trial attorney enters into an employment contract with his corporation at the start of the year, agreeing he will accept $360,000 for his services rendered during that year.'' He follows with commentary about all the attorneys that make far less than that and how Joe Sixpack might respond to that fact. That is really beside the point. But Joe Sixpack would recognize one thing for sure in Mr. Daley's example: *The trial attorney was not dealing at arm's length*.[2] In such cases, the courts can and often will ignore the agreement and analyze the substance of the matters at issue. Sole owners of corporations are given some deference in figuratively operating their corporation as a separate business entity, but the courts clearly recognize and often address the opportunity for their owners to have their cake and eat it too.

As CPAs we frequently deal with S corp. salary vs. pass-through earnings, likely far more often than lawyers. Recently, following the Edwards discussion in *Tax Notes*, this writer took a poll — admittedly informal and anecdotal — of some members of both the California CPA Society's Committee on Taxation and the Los Angeles Chapter's Taxation Committee.[3] Each of the members queried has faced the issue involving significant dollar amounts in the past few years. It was interesting that most of those commenting recognized the factual situation as one that arises more often than one would imagine and only a couple of them (since the writer only described the facts, not the player) connected those facts to Edwards (we obviously need to get *Tax Notes* into the hands of more readers).

---

[1]My observation is that Joe Sixpack can distinguish between very expensive lawyers and not-so-expensive lawyers and probably feels that ''hitting the jackpot'' in connection with legal services is actually somewhat different than winning the lottery. That would be particularly so when the attorney is collecting monies that seem to belong to the client first, if one follows the ongoing debate over attorney fees arising from damage cases right here in *Tax Notes* (although Robert Wood would certainly disagree with my description that lawyers' monies ever belonged to the client).

[2]Yes, recognizing corporate ''niceties'' will perhaps shield a 100 percent owner from some problems, but it is very unlikely with respect to employment agreement issues of this nature.

[3]The writer is chair of the Los Angeles committee. It should be noted that the opinions expressed herein are those of the author and not of the society or of its committees.

The most aggressive of those practitioners would have paid at least 70 percent of the total income in the form of salary and bonuses. The general consensus was somewhere between 85 percent and 95 percent. Of course, that's not how all accountants might view the situation, but my take is that it reflects how some experienced and pretty savvy practitioners handle real-life situations in California. Universally they agreed that a little greed is acceptable in terms of Medicare tax reduction but that the instant facts of the particular example showed a taxpayer being a true pig about it.

Mr. Daley cites the court's analysis in *Pediatric Surgical Assoc. P.C. v. Commissioner*, T.C. Memo. 2001-81, *Doc 2001-9587, 2001 TNT 64-13*, as authority for ''dividend treatment'' of Edwards's pass-through income. My original Edwards viewpoint (*Tax Notes*, Sept. 6, 2004, p. 1092) actually took into consideration (or at least addressed) the ''associates'' issue. Moreover, in reading the *Pediatric Surgical* decision in its entirety, one is not certain whether the Tax Court would have held anything similar to that decision if the Edwards case came before it.

Also, in this regard, *Yeagle Drywall Co. Inc. v. Commissioner*, 54 Fed. Appx 100, AFTR2d 2002-7744, *Doc 2002-27688, 2002 TNT 244-12* (3d Cir. 2002), applied a similar test and treated the contested withdrawals as wages, as noted by University of California at Davis law professor Daniel L. Simmons. (see 56 *Major Tax Planning* par. 602.3 (Planning and Pitfalls for Closely Held Corporations)).

Mr. Daley also presents five different business structures for a business operated by Mr. Smith over a five-year period and arrives at certain conclusions in an effort to demonstrate that the Medicare taxes paid are dramatically different for the same Mr. Smith who earns substantially the same amounts in each of the five years.

In Year 1, Mr. Smith is a sole proprietor and pays Medicare tax on all the income of the business. In Year 2, Mr. Smith is a 99 percent general partner and his son a 1 percent general partner and Mr. Smith pays Medicare tax on that 99 percent of the income.

In Year 3, the partnership is converted to a limited partnership and Mr. Daley concludes that Mr. Smith will not pay *any* Medicare tax on his 99 percent earnings. That may be true but (1) I believe the IRS might argue otherwise and (2) Mr. Daley concludes that the conversion comes without other negative tax and business consequences that might make the avoidance of Medicare tax a very costly mistake for Mr. Smith. And if Mr. Smith's son serves merely as his alter ego, the IRS may find other arguments to make. And yes, Mr. Smith's management activities may well make him a general partner under a particular state law. In other words, Mr. Smith has a gauntlet to run and it is by no means certain that he will successfully do so.

In Year 4, Mr. Smith converts the limited partnership to a limited liability company and names his son as managing partner[4] and Mr. Daley rightfully characterizes the Medicare tax element as an unresolved item. This writer has an idea how the IRS would like to characterize it and believes that Congress may ultimately lend a sympathetic ear — all it will take is a few more John Edwards situations and we may well get a bright-line test that requires Medicare tax be paid on the unsalaried profits of any limited liability business organization described in section 448(d)(2) or section 269(b)(1) without the control requirements.

I believe this may well be where we are heading if tax professionals insist on passing through 70 percent to 90 percent of S corporation, LLC, or LP income sans Medicare tax liability. Eventually, Congress will conclude that if we can't discipline ourselves and our clients, then they'll have to do so, as it has done with other tax shelters.

In this case, if the discussion in *Tax Notes* of the issue is helpful to the Treasury and IRS, it will be gratifying.

Finally, Mr. Daley has essentially argued (in both of his letters) that legal fees arising from the big settlements are like winning the lottery or are some kind of ''jackpot'' realized by the attorney's client and, accordingly, the legal fees are an equivalent for the lawyer. My understanding is that the judiciary still requires damage awards to have some basis in fact to support the amount awarded (not that I agree with that basis) and particularly that legal fees are supposed to bear *some resemblance to the value of the services rendered by the attorney(s)*. If this is not true and damage awards and the related legal fees are acknowledged by the legal profession itself, and especially by the judiciary, to equate with hitting the jackpot, then it speaks volumes about a profession that often holds itself out as the savior of mankind in America. It would serve as ample validation of Shakespeare's notorious comment.

Kip Dellinger, CPA
Dellinger & Dellinger
Los Angeles
October 5, 2004

[4]Query, what are the gift tax consequences, if any?