

# Personal Service Corporations: A Waltz Through the Minefield

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All section references are to the Internal Revenue Code (“IRC”) unless otherwise indicated. “AICPA” refers to the American Institute of Certified Public Accountants; “IRS,” to the Internal Revenue Service; “PSC,” to personal service corporation; “Secretary,” to the U.S. Secretary of the Treasury; and “Treasury,” to the U.S. Department of the Treasury.

## **A. Introduction**

1. The U.S. Treasury’s exposure to service corporations had its beginnings in the late 1960s and early 1970s when the IRS refused to recognize as taxable entities those corporations being formed under professional corporation statutes of the various states. The attacks were waged through audits and litigation premised on the view that professional corporations were illegitimate creations of lobbying groups in various states that had no semblance to a business. The individual service provider was the creator of the income, not the corporation, claimed the IRS, and continued its attack on an assignment-of-income theory. Finally, in the early 1970s the IRS acquiesced to the cases it lost and formally recognized professional corporations.

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2. As the professions developed and the services provided broadened into areas not requiring licensure, the selective rules desired by the Treasury broadened to nonprofessional service corporations as well.
3. Legislation proliferated against service corporations to the extent that they now need special attention. The IRC is riddled with provisions affecting various types of service corporations.
4. It is difficult to identify when and which corporation is being identified under each relevant provision of the IRC. Although some situations are clear, there are many that may fit one or several of the nine definitions or concepts of service corporations discussed below but not fit others.

#### **B. Identification of a Service Corporation.**

1. There are nine different types and definitions of service corporations that are the subject of restrictions or penalties under the IRC. In addition, state law has its own classifications of service corporations that must be considered in some instances for state income tax purposes. The first step in analyzing the situation for a client corporation is to determine if the client is subject to any of these restrictions by meeting the definitions. If the definition is met then the substantive restriction would be reviewed and planning would either attempt to minimize the effect of the restriction, or change the entity to fall outside of, or arguably outside of, the definition
2. *IRC*. Because the tax definition of a "corporation" includes associations (*see* §7701(a)(3)), limited liability companies, or any other entity electing to be taxed as a corporation under the "check-the-box" rules will likewise be subject to all of the rules discussed below.
  - a. *PSC I (§269A(b))*. Section 269A empowers the Secretary to reallocate income and tax attributes between PSCs and employee-owners if the conditions stated in the statute are satisfied. This definition is also used to disallow deductions for golden parachute payments made to PSCs that are treated as individuals. §280G(c) and *Treas. Reg. §1.280G-1, Q&A-16*. A PSC "means a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners." "Employee-owner" is an employee that owns, at any time during the taxable year, more than 10 percent of the stock of the corporation. Attribution under section 318 applies except that the attribution from a corporation can occur with five percent ownership rather than the

50 percent ownership identified in section 318(a)(2)(C). The proposed Treasury Regulations do not give any guidance on interpreting the words “principal activity,” “substantially performed,” and “personal services.”

- b. *PSC II (§469(j)(2))*. The definition of the second type of PSC is a modification of the first definition described above from section 269A. Falling within this definition would subject the corporation to limits on the deductibility of passive losses under section 469(a) and tax shelter farm activity losses under section 58(a)(3). This definition is broader than the above definition because employee-owner applies to an employee that owns any stock in the corporation. In addition, the attribution of ownership of a corporation under section 318 will apply regardless of the level of ownership of the attributing corporation.
  - i. To temper the breadth of the application of this definition for any type of ownership by an employee whatsoever, the definition of PSC II will not apply unless more than 10 percent of the stock by value in the corporation is held by employee-owners. This would exclude, for example, corporations that provide personal services that are publicly-held where employees collectively own 10 percent or less of the stock.
  - ii. On February 19, 1988, the Treasury issued temporary Treasury Regulations that specifically incorporated the definition of PSC found in Temp. Treas. Reg. §1.441-4T(d). Temp. Treas. Reg. §1.469-1T(g)(2). This represents a positive step in consolidating these different concepts of a PSC.
- c. *PSC III (§441(i)(2))*. This definition is the broadest of the PSC definitions and is identical to PSC II except that all members of an affiliated group filing a consolidated tax return are to be taken into account in applying the definition. Unlike the other definitions, this one has been clarified by temporary Treasury Regulations. This was necessary to allow corporations to determine if they need to change from a fiscal year to a calendar year.
  - i. Even though this definition incorporates the section 269A definition, the temporary Treasury Regulations are clear that they apply only to section 441 ostensibly leaving sections 269A and 469(j)(2) still uncertain, contrary to Temp. Treas. Reg. §1.469-1T(g)(2) discussed above. Therefore, clarification of the terms “principal activity,” “substantially performed,” and “personal services” found in these Treasury Regulations may not be relied upon for such other sections.

- ii. If employee-owners' compensation cost is 20 percent or more of the total compensation cost of employees of the corporation providing services then they are "substantially performing" these services. Temp. Treas. Reg. §1.441-4T.
  - iii. An S corporation cannot be a PSC III. *Id.*
  - iv. An "employee-owner" can be a non-employee independent contractor.
  - v. Only those services included in the definition of qualified PSCs below (and as described in the section 448 Treasury Regulations) will be deemed to be "personal services." *Id.*
  - vi. The "principal activity" requirement is met when more than 50 percent of compensation costs are for those employees performing personal services or supporting providing that service. *Id.*
- d. *PSC IV (§465(c) (7)(B)(iii))*. This definition is identical to PSC I except only five percent ownership is required to be an "employee-owner" rather than the 10 percent in section 269A(b). The "at risk" rules do not apply to a qualified active business activity in a qualified C corporation. A PSC IV is not eligible to be a "qualified C corporation."
- e. *Qualified Personal Service Corporation (§448(d)(2))*. This definition is much more focused than the previous four PSC definitions above and dictates if the cash method of accounting is available. It is important to note that a "qualified" PSC is *not* a subset or a type of any of the PSCs described above. It is a distinct definition that requires "substantially all" of the activities of the corporation involved in the performance of service in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.
- i. In addition to the type of activity requirement, there is the ownership requirement that "substantially all" of the stock of the corporation that is held directly or indirectly by employees performing services for the corporation in connection with the activities involving a field referred to above. This ownership requirement may also be satisfied by retired employees who have performed such services, the estates of the retired or current employees, and any successor in interest to their stock for a two-year period beginning with the date of death of such person.

- ii. Fortunately, on June 12, 1987, the Treasury issued temporary Treasury Regulations that identified 95 percent or more as “substantially all.” This 95 percent is based on time spent by employees rather than measuring by compensation or payroll.
- iii. The Treasury Regulations attempt to explain the particular fields of service but the term “directly or indirectly” remains somewhat mysterious. Some of the mystery was rectified in the section 448 temporary Treasury Regulations which described “indirectly” in much different terms as would be the case under section 318 attribution. A 1988 amendment to section 448(d)(2)(B) enhanced “indirectly” to state: “indirectly through 1 or more partnerships, S corporations, or qualified PSCs not described in paragraph (2) or (3) of subsection (a). . . .”
- iv. Note that the definitions above for the four PSCs used the attribution rules of section 318 for “indirect” ownership. There is no such use of the attribution rules for a qualified PSC. This opens avenues for planning using family members as shareholders where local law does not require a professional license for ownership.
- f. *Certain Service Corporations (§535(c)(2)(B))*. A “certain service corporation” is one where the “principal function” is the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. Although the definition is similar to the “qualified personal service corporation,” there is no ownership aspect to the definition. Again, we are at a loss to distinguish a corporation whose “principal function” is in one of these fields versus a “principal activity” in the PSC definitions. A “certain service corporation” has a minimum accumulated earnings credit of \$150,000 rather than the \$250,000 enjoyed by all other corporations.
- g. *Certain Corporations (§263A(h)(3)(D))*. A “certain corporation” is one that is owned substantially all by writers, photographers, or artists and members of his or her section 267(c)(4) family and the principal activity is the performance of such writing, photography or art services. The “qualified creative expenses” of a certain corporation is not subject to the uniform capitalization rules of section 263A.
- h. *Service Organizations (§414(m)(3))*. A “service organization” is a corporation, partnership, or other organization the “principal business” of which is the performance of services. The proposed Treasury Regulations pro-

vide that the “principal business” of an organization is services if they are engaged in certain activities (the eight qualified PSC activities described above plus insurance) or if capital is not a material income-producing factor. Meeting this definition could cause the organization to be a member of an affiliated service group treating all members as a single employer for benefit plan purposes and possibly resulting in the organization not being able to have a qualified plan under section 401(a) because of the minimum participation rules under section 401(a)(26). In addition, a “service organization” has availability of the research activity credit affected under section 41(e)(7)(E)(iii).

- i. *Professional Service Corporation (Prop. Reg. §1.414(m)-1(c))*. A “professional service corporation” is a corporation organized for the principal purpose of providing professional (i.e., accountants, actuaries, architects, attorneys, chiropractors, chiropractors, medical doctors, dentists, engineers, optometrists, osteopaths, podiatrists, psychologists, and veterinarians) services and has at least one shareholder who is legally authorized to perform such service. Only professional service corporations may be considered “First Service Organizations” under section 414(m) which narrows the scope somewhat of affiliated service groups.
  - j. *Summary of Dealing with IRC Provisions*. In summary, the tax practitioner is required to distinguish a principal activity (§§269A, 469, 441, and 465), substantially all of the activities (§§448, 11), principal function (§535), principal business (§414(m)), and principal purpose (Prop. Reg. §1.414(m)-1(a)) just to ascertain the proper degree of the corporation’s involvement. There then remains the analysis of type of activity and ownership.
3. *Service Corporations Under State Statutes*.
    - a. *Professional Corporations*. The purpose of Professional Corporation Acts in most states is to allow the practice of licensed and regulated professions to be carried out in a corporate form. Typically, a “professional corporation” is a corporation organized for the purpose of rendering medical, surgical, chiropractic, nursing, optometric, psychology, dental, pharmacy, podiatry, veterinary, architectural, legal, or accounting services under a state issued license. Some states, such as Illinois, further complicate the area by having additional types of corporations (e.g., service corporations or specific types of nonprofit corporations). With the advent of new forms of entities (i.e., limited liability companies, limited liability partnerships and limited lia-

bility limited partnerships), some states have enacted statutes to deal comprehensively with all professional entities (*see, e.g., Minnesota Statutes Chapter 319B for Professional Firms*).

- b. *Service Corporation Classifications for State Income Tax Purposes.* Some states have evolved policies similar to the Federal government concluding that certain service corporations are not entitled to the treatment and benefits enjoyed by their nonservice-oriented counterparts. For example, in Minnesota, a “professional service corporation” was denied an exemption from the state alternative minimum tax. This was a corporation whose “sole or primary business activity” was the providing of services listed in the professional corporation statute. This definition made it possible to be a professional corporation without also being a “professional service corporation.” Identify any such local rules that may apply to service corporations.

### C. Why Not Surrender and Unincorporate?

1. Before delving too deeply into planning for the service corporation, consider the desirability of being incorporated in the first place. After all, a service corporation that becomes a partnership, limited liability company, or proprietorship can escape the minefield.
2. *Limited Liability.* This continues to be a primary factor for incorporating. In a nonprofessional service corporation, the owners enjoy an exposure to liability only to the extent of their capital in the corporation. There are many service businesses in which you would not conceivably be involved unless personal liability could be limited (e.g., waste disposal). In a professional corporate setting, the limitation of liability is intact with the exception of actions of the shareholder himself or herself. However, protection against liability for the acts of fellow shareholders or other employees, as well as general business liability, is valuable and very comforting.
  - a. A limited partnership would only expose the general partner, which may be a corporation. A corporate general partner may find that it is some sort of PSC.
  - b. A limited liability company is designated to protect its members from liability and, therefore, may be a suitable alternative.

3. *Ease of Ownership Transfer and Succession.* A corporation is a type of entity designed for business transactions. Ownership represented by shares of stock that are subject to agreement as well as articles and bylaws provides a desirable system for allocating ownership. Partnership and limited liability company ownership has tremendous flexibility but can also prove to be complicated and burdensome in transfers.
4. *Governance.* The governance of a corporate entity is also designed for the operation of a business, service corporations being no exception. The structure with a board of directors and officers creates a natural management system for the operation of the business. A limited liability company is modeled after the corporate governance structure and, therefore, may provide the same advantages.
5. *Business Expenses.* The Tax Reform Act of 1986 imposed a two percent threshold on employee business expenses being deducted on Schedule A of an employee's income tax return. These expenses can be paid by a corporation without the two percent floor. Flow-through entities carry limitations on certain deductions to owners.
6. *Accumulation of Capital.* The corporation, being a separate taxable entity, allows use of lower tax brackets at the corporate level to accumulate capital for the needs of the business. A qualified PSC has a flat tax rate of 35 percent which, before the 1993 Tax Act, offered no tax savings to most owners whose marginal tax bracket was between 28 percent and 33 percent. Now with a 36 percent bracket and a 10 percent surtax resulting in a 39.6 percent bracket plus recapture of itemized deductions and personal exemptions, owners may find themselves in a marginal tax bracket six percent or more higher than even the qualified PSC.
7. *Conversion Issues.* Based on the above analysis, a service corporation may determine that it should convert to a limited liability company or limited partnership. Aside from organizational and transitional issues among owners in converting from a corporation, the recognition of gains on appreciated property, such as goodwill, may very well preclude converting. Restrictions on transfers of property and contract rights (e.g., leases) may also preclude conversion.

#### **D. Cash Basis Accounting.**

1. The Tax Reform Act of 1986 precluded corporations (other than S corporations) from using the cash basis of accounting. A qualified PSC is one of the



three exceptions to this rule. Therefore, a qualified PSC may use the cash method of accounting regardless of the level of income. It is noteworthy that one of the other exceptions applies to corporations that have never (after 1985) exceeded \$5 million of gross receipts in a taxable year. Therefore, all corporations, including service corporations that do not meet the “qualified personal service corporation” definition, that meet this test may keep the cash basis method of accounting.

2. Section 448 qualification most likely has the most attention and planning under all of the PSC definitions. This is because it is the only one that can actually provide a benefit to a corporation, versus a penalty. Even though the flat tax of 35 percent applies to a qualified PSC, the benefit of being on a cash basis accounting may far outweigh the lack of graduated tax rates. The limited guidance for this qualification is found in Treas. Reg. §1.448-1T(e). These Treasury Regulations are fairly generous in defining a qualified PSC for both the ownership test and the activity test.
3. Although the Treasury Regulations do not specifically say so, it seems clear that the ownership test may be met by shareholders that provide services in any combination of the eight categories identified in section 448. Therefore, it is not necessary that all of the owners work in the same field of service. This is helpful for an entity that may be owned by a combination of, e.g., lawyers and accountants or accountants and actuaries. This is indirectly confirmed in two parts of the Treasury Regulations. Subsection (e)(5)(vi) identifies a special election for certain affiliated groups. This provision allows an entire section 1504(a) group to use the cash method of accounting as a qualified PSC only if the activities and ownership are by individuals in the same specific field. This requirement of being in the “same field” implies that for nonaffiliated group situations this requirement would not be present. The other indication is found in a parenthetical in subsection (e)(5)(vii) example 7 which identifies an entity that is owned by engineers and architects.
4. For the activity test, the Treasury Regulations are similarly generous in allowing activities being “related to” one of the qualifying fields of service. The Treasury Regulations are clear that any combination of services in the listed fields qualifies. *See* Temp. Treas. Reg. §1.448-1(T)(e)(4). Although the statute requires activities “which involve” services in the identified fields, the Treasury Regulations use a “incident to such activities” measure. *Id.*

5. Example 1 of (e)(5)(vii) identifies secretarial, janitorial, purchasing personnel, security and payroll services as being incident to the primary service. For the primary service of engineering, the regulation also has a parenthetical that includes surveying and mapping Temp. Treas. Reg. §1.448-1(T)(e)(4). These generous interpretations seem rooted in the fact that the graduated flat tax rate of 35 percent applies to these entities.
6. In the recent case of *Alron Engineering and Testing Corp v. Commissioner*, 80 T.C.M. (CCH) 603 (2000), the taxpayer engineering corporation took the position that it was not a qualified PSC under section 448 to take advantage of the graduated tax rates. The IRS contended that the corporation did need meet the definition and, therefore, was subject to the flat 35 percent tax rate. The Tax Court held that geo technical services provided by the engineering corporation did not require the same education or training as engineering and those services were not dependent on the corporations ability to provide engineering services. That being the case, none of the activities involved in geo technical testing was able to be included in the “substantially all test” and, therefore, the taxpayer won.
7. The effect of this decision is to call into question the expansive view of the IRS as expressed in the Treasury Regulations on these activities. For instance, it is not uncommon for engineering firms, in particular, to provide surveying services, environmental analysis, and other related services that are likewise found in nonengineering firms. The Treasury Regulations historically gave comfort to these engineering firms that the cash method of accounting was available under section 448. The Tax Court has substantially reduced that comfort level.

#### **E. Flat Tax Rate and Accumulated Earnings.**

1. Out of the nine definitions described above only the “qualified personal service corporation” definition directly applies to more than one statute. Section 11(b)(2) deprives a qualified PSC from the progressive tax rates available to all other corporations. Therefore, there is a flat Federal tax rate of 35 percent that applies to the first dollar of taxable income of a qualified PSC.
2. Planning should be considered to avoid this flat tax. If a corporation has more than \$5 million of receipts in a taxable year and there is an opportunity to add activities to the entity so that not “substantially all activity” (i.e., 95 percent, per Treasury Regulations) is the performance of the itemized services, then the tradeoff is losing the cash basis of accounting in exchange for acquiring

the progressive tax rates. If receipts are less than \$5 million, then adding activities will avoid flat tax without losing the cash basis accounting.

3. Section 535(c) describes the accumulated earnings credit which defines the amount of unappropriated retained earnings that may be kept by a corporation without the accumulated earnings tax penalty. The general rule allows for \$250,000 of accumulated earnings. However, if a corporation meets the "certain service corporation" definition, the limitation is \$150,000. For those corporations that are also qualified PSCs subject to the flat 35 percent Federal tax rate, this lower limit is less of a problem because it is not as desirable to retain earnings.

#### **F. Taxable Year**

1. A corporation meeting the definition of a PSC is required to use a calendar year taxable year under section 441(i) unless it establishes a business purpose for having a different year. This statute was passed as part of the Tax Reform Act of 1986 and, because trusts, S corporations and partnerships were also required to conform to a calendar year, the AICPA successfully fought for an alternative in the 1987 Tax Act to provide relief to the tax return preparer.
2. *Fiscal Year Election.* PSCs subject to the calendar year rule had an opportunity to elect to keep their fiscal years (§444). This election, however, was not available to PSCs that were part of tiered structures. §444(d)(3). This election applies to those entities that had noncalendar taxable years in 1986 that wished to maintain them as well as new PSCs or PSCs changing their taxable years. The noncalendar taxable year selected by the new PSC must be either September, October, or November year-end. Entities changing their taxable years may only change to have their years end in a later month and in no event earlier than September 30.
3. *Deduction Limitation for Employee-Owner Payments.* The price a PSC pays for electing a noncalendar taxable year (unless it is able to demonstrate to the satisfaction of the Secretary that it has a business purpose to be on a noncalendar year) is that it is subject to the rules of section 280H potentially deferring the corporate deduction for payments to employee-owners to the following taxable year. Following this outline is an illustration prepared by the AICPA describing the application of the rules under section 280H.
  - a. The significance of losing a deduction for payments to employee-owners is exaggerated by two factors. The first factor would be if the PSC was also

a qualified PSC in a 35 percent Federal tax bracket. The application of section 280H would then cause a heavy tax on the amount deferred to the following year. The second factor makes that tax permanent in disallowing net operating loss carrybacks to any (or from any) taxable year in which the PSC was under a section 444 election (§444(e)). Therefore, if \$10,000 of payments to employee-owners was disallowed as a deduction under section 280H, there would be an additional Federal tax resulting of \$3,500 which could not be recouped by the use of a \$10,000 deduction creating a loss in the following year.

- b. The deduction limitation of section 280H will apply unless the corporation meets the minimum distribution requirements for the taxable year. If the minimum distribution requirements are not met, the corporation will be limited to a deduction for payments made to employee-owners (as defined for PSC I definition above) equal to the extrapolated total based on the average monthly payments in the portion of the taxable year prior to January 1. If the corporation is not “rear-end loading” its payments to shareholder/employees, then there is no limitation on the deduction.
4. *Minimum Distribution Requirement.* To avoid limitation on deduction of payments to employee-owners, the corporation may meet either of the following tests for the taxable year.
    - a. *Prior Year Payout Test.* If the amounts paid to employee-owners for the period of the taxable year prior to January 1 equals or exceeds the average monthly payments for the entire prior taxable year multiplied by the number of months before January 1 in the taxable year, then this minimum distribution test is met.
    - b. *Historic Payout Test.* If the amount paid during the period of the taxable year prior to January 1 represents at least the same (but need not be more than 95 percent) of the taxable income (computed without regard to deductions for payments to employee owners) of the period before January 1 as paid out for the previous taxable years.

## **G. Passive Losses**

1. A corporation meeting the definition of PSC II above is subject to the passive loss limitations that apply to individuals and closely held C corporations (§469(a)(2)(C)). Service corporations that do not meet the definition of PSC II (§469(j)(2)) may still be subject to the passive loss limitations as closely-held

businesses which is described in section 542(a)(2). If five or fewer individuals own more than 50 percent of the value of the outstanding stock of the corporation, directly or indirectly, at any time during the last half of the taxable year then the requirement for closely-held C corporation is satisfied.

## **H. Reallocation of Income**

1. A corporation that meets the definition of PSC I and who performs substantially all of its services for one other entity is subject to the Secretary's reallocation of income and tax attributes to employee-owners if the Secretary finds that the principal purpose for forming the corporation was for avoidance of taxes §269A.

## **I. Aggregation of Entities for Benefit Plans**

1. To prevent the use of separate entities for the purpose of design of benefit plans, sections 414(m), (n), and (o) were enacted over a period of years to create an incredibly broad network of entities that will be deemed to be related for meeting requirements under statutory benefit plans. Unlike sections 414(b) and (c) which aggregate business based strictly on common ownership, sections 414(m), (n), and (o) use functional tests requiring analysis of interrelationships among entities.
2. Corporations meeting the "service organization" definition described above will be grouped with other service organizations that are deemed affiliated under the rules in this section. The result is that all of these service organizations are deemed to be a single employer for purposes of many of the requirements of a qualified retirement and other benefit plans.
3. This becomes particularly unmanageable when the section 401(a)(26) minimum participation rule is applied. This rule requires the lesser of 40 percent of non-exempt employees or 50 participants to be in each plan. Status as a service corporation in a section 414(m) affiliated service group may ultimately require the corporation to have the same benefit plan as a whole chain of corporations. If some of the other corporations (some of whom cannot be identified) fail to conform their plans, all plans could be disqualified.
4. For example, Dr. A is a 20 percent shareholder of his medical practice, Clinic, P.A. and a one percent limited partner in Imaging, Ltd. Imaging, Ltd. does diagnostic imaging for patients of practices in the region, including Clinic, P.A. Imaging, Ltd. has 15 nonexempt employees and Clinic, P.A. has eight.

Dr. A's fellow shareholders are not even aware of Dr. A's ownership in Imaging, Ltd. and adopt a defined benefit pension plan. This plan is disqualified under section 401(a)(26). This is because Clinic, P.A.'s plan only covers approximately 35 percent of the total employees of Clinic, P.A. and Imaging, Ltd. (i.e., 8 divided by the sum of 8 + 15) which fails the 40 percent test).

#### **J. Planning Measures and Remedies.**

1. In spite of the focus on the tax on service corporations, there are measures which may be taken to mitigate or eliminate the harsh effects.
2. *Dissolve the Corporation.* An alternative form of organization may be suitable for the particular situation and many of the handicaps of being incorporated can be eliminated. The dissolution itself has certain costs and tax ramifications that would need to be considered prior to taking this step.
3. *Restructure the Corporations.* Many of the different types of definitions of service corporations described above are susceptible to being avoided with proper planning of stock ownership, removing or adding activities or services performed by the entities, merging or forming other separate entities or other means. Careful analysis must be done to ensure that the cure is not worse than the disease.
4. *Elect S Corporation Status.* Although an S corporation presents a whole new set of issues described below, it is a means of avoiding several of the drawbacks from which service corporations suffer.
5. The Technical and Miscellaneous Corrections Act of 1988 created a tremendous risk of any existing operating service corporation electing to be an S corporation. It would create a 35 percent Federal tax on collection of accounts receivable as built-in gain. The gains may, with proper planning, be offset with built-in losses. The amount subject to tax does not exceed taxable income of the corporation over 10 years had the corporation been a C corporation.

#### **K. Simplification Proposal.**

1. Attached is a draft of a proposal submitted to the ABA Tax Section for recommending to Congress the simplification of this area to have a single definition of "service corporations."
2. All of the rules would then apply to such corporations.

## Appendix

### AICPA Fiscal Year Election Illustration

#### PERSONAL SERVICE CORPORATIONS

##### *Explanation of the Fiscal Year Retention Alternative for Personal Service Corporations*

Under the recently introduced legislation, a PSC, which is otherwise required to change to a calendar year, could elect to retain its fiscal tax year. Again, this optional election would be made at the corporate level. If payments to owner-employees are not made ratably before and after December 31, the electing PSC will have to postpone some or all of its deduction for such payments until the following fiscal year. In order not to postpone any of the deduction, the payments to owner-employees prior to December 31 must exceed a minimum distribution amount. This minimum distribution amount is the lesser of two figures, one based on prior year's payments and one based on current year's income and payments:

*Prior Year's Pro Rata Payments* - All payments that constitute gross income to an owner-employee (other than taxable dividends and gain from the sale or exchange of property) paid to owner-employees in the prior fiscal year, divided by 12, and multiplied by the number of months in the PSC's fiscal year before December 31; or

*Historical Payout Percentage of Current Earnings* - A historical payout percentage (not in excess of 95 percent) times the taxable income of the corporation for the period from the first day of the entity's fiscal year through the end of the calendar year. The historical payout percentage is equal to the total payments paid to owner-employees in the preceding three taxable years, divided by the total earnings before total payments to owner-employees for the same three year period.

##### *Calculation of the PCS's Postponed Deduction*

A PSC which elects to retain its fiscal tax year and does not meet the minimum distribution requirement detailed above, may deduct only the amounts paid prior to December 31 annualized to a 12-month basis. Any payment of salary or bonus that is not deductible in a taxable year as a result of this rule is deductible in the following taxable year of the PSC. The maximum deduction for payments to owner-employees, in a year when the minimum distribution requirement is not met, is calculated as follows:

$$(P) (12/\times)$$

P = total payments to owner-employees on or before December 31 of the current fiscal year

× = number of months in entity's fiscal year before December 31

## PERSONAL SERVICE CORPORATION

*Assumptions*

PSC is on January 31 fiscal year

Year Ended	Adjusted Taxable Income	Previous 3 Years	Salaries to Owner/Employees	
			Examples 1	2
01/31/00	\$100,000	\$100,000		
01/31/01	130,000	110,000		
01/31/02	<u>150,000</u>	<u>132,000</u>		
	<u>\$380,000</u>	<u>\$342,000</u>		
01/31/03				
Feb-Dec '02	\$140,000		\$125,000	\$88,000
Jan '03	<u>28,000</u>		<u>13,000</u>	<u>50,000</u>
	<u>\$168,000</u>		<u>\$138,000</u>	<u>\$138,000</u>

*Calculation of minimum distribution requirement:*

Lesser of:

A. Pro rata share of prior year's salaries $11/12 * 132,000$	\$121,000	\$121,000
B. Historic percentage of current year's income to Dec. 31 $342,000/380,000 = 90$ percent 90 percent * 140,000	\$126,000	\$126,000
Salaries paid before 12/31	\$125,000	\$88,000
Distribution requirement is	<i>Met</i>	<i>Not met</i>

*Calculation of maximum deduction:*

Salary deduction allowed for year ended

01/31/03		
Example 1 - allowed in full	\$138,000	
Example 2 - actual salary payments prior to 12/31/ annualized to 12-month basis: (P) $(12/X) = 88,000 \times 12/11 =$		\$96,000
Salary deduction deferred to fiscal year ending 01/31/04	<i>None</i>	
$138,000 - 96,000 =$		\$42,000

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