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Big News for Non-CPA Accountants

Practicing As A Corporation

-by Neil E. Harl*

A Tax Court case, *Rainbow Tax Services, Inc. v. Commissioner*,¹ decided March 8, 2007, has broadened the "personal service corporation" rules to include tax return preparation and bookkeeping services.² That is a major development for non-CPA accountants who are practicing as a corporation.

The history of "personal service corporations"

The Omnibus Budget Reconciliation Act of 1987,³ amended I.R.C. § 11(b) to deny the corporate graduated rates to "personal service corporations."⁴ Instead, personal service corporations are taxed *at a flat rate of 35 percent of taxable income*.⁵

"Qualified personal service corporations" are defined elsewhere⁶ to include corporations "... substantially all of the activities of which involve performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. . . ." "if specified conditions are met."⁷ That is referred to as the "covered services" test.⁸ The rules apply to corporations where substantially all of the stock (by value) is held, directly or indirectly, through one or more partnerships, S corporations, or qualified personal service corporations by employees performing services in the field, retired employees who had performed such services, estates of individuals in those two categories and others who acquired stock by reason of death of such an individual providing services for the corporation, for two years after the death.⁹ Temporary regulations provide guidance on this "ownership test" and specify that if 95 percent of the corporation's stock is owned by, among others, individual employees performing covered services for the corporation (or by the estate of a prior employee who performed covered services), and the employees spend 95 percent or more of their time in covered services, it is a qualified personal service corporation.¹⁰ Neither the regulations nor the statute define "accounting services."¹¹

Under another provision, if substantially all of the services of a personal service corporation are performed for, or on behalf of, another corporation, partnership or other entity and the principal purpose for forming or using the personal services corporation is the avoidance or evasion of income tax by reducing the income or securing the benefits of any expense, deduction, credit, exclusion or other allowance, IRS has authority to reallocate the expense, deduction, credit, exclusion or other allowance between the

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personal service corporation and its employee-owners to more clearly reflect income of both taxpayers.¹²

The case of *Rainbow Tax Services, Inc.*

The focus of *Rainbow Tax Services, Inc. v. Commissioner*¹³ however, was on the loss of the corporate graduated rates. In that case, the corporation involved was engaged in tax return preparation and bookkeeping services.¹⁴ The tax return preparation services generally consisted of preparing clients' federal and state individual, corporate and partnership returns as well as gift and estate tax returns. The bookkeeping services consisted of the preparation, from client records, of profit and loss statements and other reports and forms relating to federal payroll taxes, state unemployment taxes and sales taxes.¹⁵ The firm in question was not a public accounting firm and did not perform work requiring Certified Public Accountant licenses.

The accounting firm defended on the grounds that it was not performing accounting services and pointed out that, under state law, accounting services can only be performed by CPAs, the firm did not employ CPAs and the firm did not perform services restricted under state law to CPAs.

The Tax Court rejected what it termed the "overly restrictive definition of accounting services"¹⁶ and pointed out that "public accounting" is a *branch* of accounting and requires a CPA license but "accounting" embraces the rest of the field of "accounting."¹⁷ The court then held that the tax return preparation services provided by Rainbow Tax Services, Inc. constituted services in the field of accounting; the court also held that bookkeeping is a branch of accounting.¹⁸

In a 2006 case, *Ron Lykens, Inc. v. Commissioner*,¹⁹ the parties did not dispute that tax return preparation services constituted accounting services. In that case, the taxpayer had split the business into an entity providing investment advice and another entity providing accounting services. However, the employees were found to devote only 80.53 percent of their time to accounting services so the firm was not a personal service corporation. As noted, the temporary regulations require 95 percent or more of the time spent by employees of the corporation for the corporation to be a personal service corporation.²⁰

Footnotes

¹ 128 T.C. No. 5 (2007).

² I.R.C. § 11(b)(2), 448(d)(2). See generally 4 Harl, *Agricultural Law* § 30.08[1][a][iii][A] (2006); 7 Harl, *Agricultural Law* § 54.06[1][b][ii] (2006); Harl, *Farm Income Tax Manual* § 1003(f) (2006 ed.).

³ Pub. L. No. 100-203, § 10224(a), 101 Stat. 1330, 1330-412 and 1330-413 (1987).

⁴ I.R.C. § 11(b)(2).

⁵ *Id.*

⁶ I.R.C. § 448(d)(2).

⁷ *Alron Engineering & Testing Corp. v. Comm'r*, T.C. Memo. 2000-335 (corporation providing geotechnical testing and engineering services was not personal service corporation and could avoid 35 percent flat rate). See I.R.C. § 448(d)(2)(A). See Rev. Rul. 91-30, 1991-1 C.B. 61, *modified by* Rev. Rul. 92-65, 1992-2 C.B. 94 (corporation providing veterinary services was personal service corporation); TAM 9222004, Jan. 8, 1992 (corporation providing physical therapy services was personal service corporation).

⁸ Temp. Treas. Reg. § 1.448-1T(e)(4)(i).

⁹ I.R.C. § 448(d)(2)(B).

¹⁰ Temp. Treas. Reg. § 1.448-1T(e)(4)(i).

¹¹ See Temp. Treas. Reg. § 1.448-1T(e).

¹² I.R.C. § 269A(a).

¹³ 128 T.C. No. 5 (2005).

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ T.C. Memo. 2006-35.

²⁰ Temp. Treas. Reg. § 1.448-1T(e)(4)(i).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

CHAPTER 12

ELIGIBILITY. The debtors, husband and wife, filed for Chapter 12 bankruptcy and a creditor objected to the debtors' eligibility for Chapter 12 based on the debtors' Schedule F income reported for the tax year before filing for bankruptcy. In particular, the creditor

argued that the proceeds from the sale of a truck and trailer were not farm income because the depreciation for the equipment was reported on Schedule C, Form 4562. The court noted that the truck and trailer were used primarily for farm operations in hauling hay, straw and cattle; therefore, the proceeds of the sale of the equipment were farm income. With the sale proceeds included in farm income, the debtors' farm income for the tax year prior to the bankruptcy petition was 51.47 percent of total income and qualified the debtors for Chapter 12. *In re Wilson*, 2007 Bankr. LEXIS 359 (Bankr. D. Mont. 2007).