



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE
MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL,

FROM: Assistant Chief Counsel (Field Service)

SUBJECT:

This Field Service Advice responds to your memorandum dated August 11, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Mr. A	=
Mrs. A	=
Year 2	=
Year 5	=
Date 1	=
State X	=

ISSUE:

Whether petitioner is subject to the 35% flat tax rate that is applicable to qualified personal service corporations (as defined in I.R.C. § 448(d)(2)).

CONCLUSION:

As discussed herein, additional factual development is necessary to determine whether petitioner is subject to the 35% flat tax rate applicable to qualified personal service corporations.

FACTS:

This case involves the Year 5 corporate income tax liability of petitioner, a corporation chartered in State X. The Service issued a notice of deficiency and a Tax Court petition has been filed. The case is now with the Appeals Division.

Petitioner is a C corporation offering engineering services. Mr. A, the president and an engineer, acquired 100% of the stock of petitioner in Year 2. Previously, the stock had been owned by several others.

On Date 1, Mr. A gifted 6% of the stock to his wife (Mrs. A). Upon questioning, you have indicated that we should assume that this gift was a bona fide gift for state law purposes, enforceable by Mrs. A against Mr. A, for example, in the event of a divorce. After the gift, 94% of the stock was held by Mr. A and 6% was held by Mrs. A.

Although the Revenue Agent's Report indicates that Mrs. A was also an employee of petitioner, those facts were not developed in the case file and you are not aware of what, if any, employment activities Mrs. A performed for petitioner. Petitioner's attorney has indicated that Mrs. A has not been an employee, although she may have performed some de minimis temporary secretarial services in the past. For the purpose of answering the main question presented, you have asked us to assume that Mrs. A was not an employee of petitioner.

Petitioner contends that the 6% stock interest held by Mrs. A prevents petitioner from being considered a QPSC because at least 95% employee stock ownership is required to be considered a QPSC. Based upon its purported non-QPSC status, petitioner contends that its tax liability should be calculated using the normal graduated corporate rates instead of the 35% flat rate used in the statutory notice of deficiency. The 35% flat rate is applicable to QPSCs under section 11(b)(2).

In the notice of deficiency, the Service took the position that the 6% stock gift from Mr. to Mrs. A should not permit petitioner to avoid the 35% QPSC flat tax rate because the transfer was a sham completed with no business purpose other than tax avoidance. In response to the Service's arguments, petitioner has proffered the following reasons for Mr. A's gift to Mrs. A:

1. To put Mrs. A in a stronger position relative to other shareholders should something happen to Mr. A;
2. To make sure Mrs. A had some direct ownership in the corporation;
3. To allow Mrs. A to have unquestioned access to corporate information;
4. To allow Mrs. A to become more involved in corporate decisions;

5. To allow Mrs. A to become more knowledgeable in the event that she needs to take over the business.

Petitioner contends Mr. A's gift was limited to 6% because he sought to give a round number of shares which would approximate, but not exceed, \$10,000 in value so that no gift tax return would be required.¹ You note that, other than giving the wife a nominal, non controlling interest in the corporation, it appears to you that there was no business purpose for the transfer of the stock.

The Appeals Division has requested your opinion as to whether the government would prevail in litigation questioning the business purpose of the stock transfer to the wife as to its substance versus form. You have, in turn, requested our opinion on the same issue.

LAW AND ANALYSIS

The primary issue in this case is whether the graduated tax rates normally applicable to C corporations apply to petitioner, or whether the flat 35% rate applicable to QPSCs applies under I.R.C. § 11(b)(2). Normally, under section 11(b)(1), C corporations are subject to a graduated tax beginning at 15% of taxable income up to \$50,000. The exception to this general rule occurs when the corporation is a qualified personal service corporation, as defined by section 448(d)(2). In that case, the tax imposed is equal to a flat 35% of taxable income.

Section 448 was designed to place limitations on when a taxpayer may use the cash method of accounting. The general rule of section 448 prohibits C corporations such as petitioner from using the cash method. One exception to the general rule prohibiting use of the cash method is when the corporation is a qualified personal service corporation. See section 448(b)(2). Another exception applies to corporations that have average annual gross receipts that do not exceed \$5,000,000. See section 448(b)(3).

A qualified personal service corporation is defined by section 448(d)(2). Section 448(d)(2) establishes two threshold tests to be used to determine if a corporation is a qualified personal service corporation. These tests are commonly referred to as the function test and the ownership test.

¹This purported purpose appears to be based upon ignorance of the law. Under I.R.C. § 2523, transfers between spouses will not result in a gift tax liability. Furthermore, under I.R.C. § 6019(2), taxpayers are relieved from the requirement to file gift tax returns for a transfer between spouses.

Under the function test, the issue is whether substantially all of the activities of the corporation involve the performance of services by certain individuals in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. There appears to be little dispute in this case that petitioner satisfies the function test.

Under the ownership test, the issue in this case is whether substantially all of the stock of the corporation (by value) is held by employee-owners.² Assuming Mrs. A is not an employee of petitioner, the key question is whether Mrs. A's ownership of 6% of the stock is sufficient to remove petitioner from the definition of a qualified personal service corporation.

Under Temp. Treas. Reg. § 1.448-1T(e)(5)(i) (flush language), for purposes of the ownership test, ownership of "substantially all" of the stock means ownership of an amount equal to or greater than 95% of the stock. Therefore, Mr. A's 94% ownership interest (assuming Mrs. A is treated as owning 6% of the stock for federal income tax purposes) is less than what is required under the temporary regulation to constitute ownership of "substantially all" of the stock.

Temp. Treas. Reg. § 1.448-1T(e)(5)(iii) provides the attribution rules applicable in this context. It provides that a corporation's stock is considered held indirectly by a person if, and to the extent, such person owns a proportionate interest in a partnership, S corporation, or qualified personal service corporation that owns such stock. No such ownership situation is present in the instant case.

Temp. Treas. Reg. § 1.448-1T(e)(5)(iii) then provides that "(n)o other arrangement or type of ownership shall constitute indirect ownership of a corporation's stock for purposes of this paragraph (e)(5)." This is good authority for the proposition that no type of family attribution rule should be applied in the QPSC ownership test context. See also H.R. Rep. No. 391(II), 100th Cong., 1st Sess. 1223 (1987) ("Thus, other forms of indirect stock ownership (e.g., as a result of attribution between family members or a holding company) are not considered in determining if the ownership test is satisfied.").

The Code and the regulations also contain rules which ignore community property interests in the QPSC ownership test context.³ Specifically, I.R.C. §

² Some other types of ownership, not relevant here, are also permitted. See section 448(d)(2)(B).

³Note the distinction between family attribution rules (which generally attribute all stock owned by one family member to another) and community property rules (which generally provide that one spouse is treated as owning an undivided one-half interest in

448(d)(4)(A) provides that community property laws are to be disregarded. This statutory provision is supported by Treas. Reg. § 1.448-1T(e)(5)(iv), which provides that stock owned by a spouse solely by reason of community property laws shall be treated as owned by the other spouse. Therefore, although Mr. and Mrs. A live in State X (a community property state), no portion of Mrs. A's 6% stock ownership interest will be regarded as owned by Mr. A in this context. See also Treas. Reg. 1.448-1T(e)(5)(vii), Example (6).

Whether the transfer of stock should be respected for tax purposes

In order to be respected for federal income tax purposes, the transfer of stock from Mr. A to Mrs. A must have economic substance. See, e.g., Specca/Madrigrano v. Commissioner, 630 F.2d 554 (7th Cir. 1980) (taxpayers' purported transfer of stock to their children lacked sufficient economic substance and, therefore, the taxpayers were deemed to be the beneficial owners for tax purposes). Economic substance frequently comes into question when there is a transfer of stock between family members. In these cases, "special scrutiny is necessary, lest what is in reality but one economic unit be increased to two or more by devices which, though valid under state law, are not conclusive" for federal income tax purposes. Helvering v. Clifford, 309 U.S. 331, 335 (1940). In order for the instant transfer to be respected for tax purposes, Mrs. A must be determined to be the true beneficial owner after the transfer, not just the owner in form alone. See Anderson v. Commissioner, 164 F.2d 870 (7th Cir. 1947), cert. denied, 334 U.S. 819 (1948).

As stated, in determining the true ownership of corporate stock, beneficial ownership, as opposed to holding mere legal title, is decisive. Beirne v. Commissioner, 61 T.C. 268, 277 (1973). See also, Mertens, Law of Federal Income Taxation § 38:09. Ownership of property is determined by command over property or enjoyment of its economic benefits. Anderson, supra, at 873. The issue of the appropriate standards to be applied in determining true beneficial ownership is a question of law. Wilson v. Commissioner, 560 F.2d 687 (5th Cir. 1977). However, the question of whether an individual meets these standards and qualifies as a true beneficial owner is a question of fact. Id.

In determining true beneficial ownership, courts have employed a four factor analysis. See Specca/Madrigrano, supra; Duarte v. Commissioner, 44 T.C. 193 (1965); Beirne v. Commissioner, 52 T.C. 210 (1969); Beirne v. Commissioner, 61 T.C. 268 (1973); Kirkpatrick v. Commissioner, T.C. Memo. 1977-281. For purposes of this discussion, it will help to address the four factor analysis in the context of two specific cases (in which opposite results were reached --

the property of the other spouse).

Specca/Madrigrano and Kirkpatrick, supra). Both of these cases involved intra-family transfers of closely-held stock by parents to their children.⁴ The issue was whether these transfers were to be respected for tax purposes. In Specca/Madrigrano, the Commissioner prevailed (i.e., the intra-family transfer was not respected by the court for tax purposes). In Kirkpatrick, the taxpayers prevailed (i.e., the intra-family transfer was respected by the court for tax purposes).

The four factors that have been used by the courts to determine the true beneficial ownership of corporate stock after a questionable transfer are discussed below:

1. Whether the transferees within the family are able to effectively exercise ownership rights of their shares.

In Specca/Madrigrano, there were two families involved -- the Specca family and the Madrigrano family. The fathers attempted to transfer stock to their children. However, Specca's two children were held not to have effective ownership rights after the transfer because they were minors without legal representatives. Although Madrigrano's two children were young adults, they were students who never actually exercised their judgment with respect to any corporate decisions. Therefore, Madrigrano's children were also held not to have effective ownership rights after the transfer.

In Kirkpatrick, the wife was named custodian for the transferee-children and she was present at all corporate meetings. She fully participated in corporate decisions, acted independently, and exercised considerable influence over corporate affairs. Therefore, the Kirkpatrick court, in effect, found that the transferee-children were able to exercise ownership rights through their custodian-mother.

With respect to the instant case, although Mrs. A had the **ability** to effectively exercise her ownership rights because she is an adult, you

⁴Although the instant case involves a transfer between husband and wife (not between parents and children), we see no distinction in this context.

should determine whether Mrs. A **actually** participated in corporate decision-making by virtue of her share holdings. We note that one of the reasons cited by Mr. A for the transfer to Mrs. A was to allow for Mrs. A to become more involved in corporate decisions.

2. Whether the transferor continued to exercise complete dominion and control over the transferred stock.

In Specia/Madrigrano, the court found that Specia retained dominion and control because, inter alia: (1) Specia signed a waiver of notice as to the 1972 shareholder's meeting on behalf of his two minor sons; (2) the minutes of the 1974 shareholder's meeting indicated that Specia's minor sons were present only by proxy without stating who the proxy was; and (3) Specia approved the minutes himself even though he was not a shareholder of record. The court also found that Madrigrano retained dominion and control because the company's main supplier insisted upon dealing the elder Madrigrano to the exclusion of his sons. The elder Madrigrano even wrote a letter to the supplier stating that the transfer of shares to his sons was effectuated only for the tax benefits.

In Kirkpatrick, the court held that the parents did not exercise complete dominion and control over the transferred stock. The court noted that, when a new child was born, the parents transferred additional stock from their personal holdings, rather than diluting the stock holdings of their other children. Such a dilution upon the birth of a new child was cited by the Tax Court in Beirne, supra, in support of the Beirne court's holding that the parents had retained dominion and control.

With respect to the instant case, you should determine whether any facts and circumstances exist, such as those described above, which would indicate whether Mr. A continued to exercise complete dominion and control over the transferred stock.

3. Whether the transferor continued to enjoy economic benefits of ownership after conveyance of the stock.

In Specca/Madrigano, the court held that the parents retained the economic benefits of the transferred stock to the detriment of their children. The court held that the cash dividends distributed to the children were in no way commensurate to the profits of the corporation. Instead, these cash dividend distributions were approximately equal to the increase in the children's tax liabilities due to the inclusion of the proportionate share of the Subchapter S corporation's income on the children's returns. Also, the court found that the parents were the recipients of sizeable, unsecured loans from the corporation that remained outstanding long after the parents transferred their stock to their children. These loans were then repaid to the corporation through the parent's use of their children's non-cash dividends (which were taken from their children as payment for the transferred shares).

In Kirkpatrick, on the other hand, the court held that the father did not retain the economic benefits of the transferred stock even though he received distributions from the Subchapter S corporation in excess of his pro rata share. With respect to the excess distributions, the court stated that the father signed promissory notes to his children (for a portion of the debt) to evidence his indebtedness to them. The court found that the mother, as custodian, was fully aware of her husband's debt to her children and adequately protected their interests.

With respect to the instant case, you should analyze the financial relationship between Mr. and Mrs. A in order to help determine whether Mr. A continued to enjoy the economic benefits of the transferred stock.

4. Whether the transferor dealt at arm's length with the corporation involved.

In Specca/Madrigrano, the court found that the parents failed to deal at arm's length in obtaining loans or in paying them back.

In Kirkpatrick, the court found that the father dealt at arm's length in that he took steps to substantiate and secure the indebtedness between him and his children. Furthermore, the court found that the father had actually repaid a significant amount of the indebtedness.

With respect to the instant case, you should examine the relevant facts necessary to determine whether Mr. A dealt at arm's length with the corporation or whether, for example, he used the corporation as his personal pocketbook.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The determination of whether an individual meets the standards for qualification as a true beneficial owner is a question of fact. Based upon the four-part test discussed above, additional factual development is necessary to determine whether Mr. A's transfer of stock to his wife should be respected for federal income tax purposes.

You have also asked us to assume that Mrs. A should not be considered to be an employee. If you determine that Mrs. A should be considered an employee, the QPSC ownership test discussed above will have been met and petitioner will be regarded as a qualified personal service corporation subject to the 35% flat tax rate of section 11(b)(2).

JAMES L. ATKINSON
Acting Senior Technician Reviewer
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