MacDonald Motors, Inc.

v.

Department of Revenue Administration

Docket No.: 16700-96BP

DECISION

The "Taxpayer" appeals, pursuant to RSA 21-J:28-b IV (Supp. 1996), the Department of Revenue Administration's (DRA) May 13, 1997 assessment of a business-profits tax (BPT) for tax year 1990. For the reasons stated below, the appeal for redetermination is denied.

Facts

In tax year 1990, the Taxpayer was a so-called "Subchapter S corporation" for purposes of federal taxation. See Internal Revenue Code (IRC) 26 U.S.C. § 1361 et seq. The Taxpayer owned and operated an automobile dealership. The three equal shareholders were brothers: Robert F. MacDonald, Daniel MacDonald and James R. MacDonald (collectively "the MacDonalds"). One of the MacDonalds worked full-time at the dealership; the two other MacDonalds worked part-time at the dealership.

In addition to being the shareholders in the dealership corporation, the MacDonalds were partners in the "Partnership" that owned the land and building where the dealership operated. The Partnership leased the real estate to the Taxpayer without a written lease, and the rental income was the Partnership's sole income.

In 1990, the Taxpayer paid $35,000 directly to each of the MacDonalds. The checks listed the payee of each check as one of the MacDonalds; the Partnership was not a payee on any of the checks. The Taxpayer's corporate ledger recorded these payments as rent. Furthermore, two of the checks stated that the payments were for rent. See DRA Exhibits B, C and D.

On the Taxpayer's 1990 federal tax return, the Taxpayer deducted, as rent, the total $105,000 of payments that had been paid by the Taxpayer to the individual MacDonalds. The federal return showed the Taxpayer did not earn any profit but rather had a loss in 1990. The federal return is the starting point for determining BPT liability. Because the federal return showed no profit, the Taxpayer filed a BPT return that reported no business profits and thus no BPT liability.

The Partnership filed its 1990 BPT return and listed the $105,000 rental income as partnership income. The return, however, deducted that full amount by attributing it all to personal services rendered by the MacDonalds to the Partnership. This was done even though at least part of the $105,000 was not due to personal services rendered by the MacDonalds to the Partnership but rather was attributable to rental income from the real estate.

The DRA eventually audited the Taxpayer's and the Partnership's BPT returns. The DRA specifically questioned the Taxpayer's and Partnership's treatment of the $105,000. The DRA and the Partnership reached an accord concerning the Partnership BPT liability, but no accord was reached between the Taxpayer and the DRA. The Taxpayer and the DRA did, however, agree that $30,000 of the $105,000 was a reasonable rental income and thus was properly deducted as rent on the federal return. The Taxpayer and the DRA continued to disagree about the correct treatment of the remaining $75,000. The DRA, in assessing a BPT liability, concluded the $75,000 was a dividend, which would not have been deductible on the federal return and would have resulted in BPT

liability. The Taxpayer asserted the $75,000 was qualified to be deducted as compensation and, therefore, would have resulted in no BPT liability.

Arguments

The Taxpayer argued the DRA should not have assessed a BPT because:

(1) the $105,000 that was reported as rent consisted of $30,000 for rent and $75,000 as compensation for services rendered to the Taxpayer by the MacDonalds;

(2) the $75,000 should be allowed as a deduction to the corporation because services were rendered, and the amount of compensation was reasonable; and

(3) Langer v. Commissioner, 59 T.C.M. 740 (1990), along with other cases, supported the Taxpayer's claim that $75,000 was deductible as compensation even if initially mislabeled as rent.

The DRA argued the BPT assessment was proper because:

(1) the Taxpayer did not treat the $75,000 as compensation on its federal tax

return and did not file an amended tax return to show the $75,000 as compensation;

(2) the Taxpayer is entitled to a reasonable rent ($30,000), but the $75,000 should be treated as a dividend; and

(3) the Taxpayer is not entitled to a deduction for compensation because the Taxpayer did not: a) prove the deduction was purely for services; b) prove the claim of the hours worked by the MacDonalds; or c) provide testimony from any of the MacDonalds.

Analysis

Under TAX 209.04, the Taxpayer has the burden to show the DRA erred in its determination. Under 21-J:28-b IV, this board "shall determine de novo the correctness of the [DRA] commissioner's actions."

Based on a review of the parties' arguments, the facts and the law, the board finds the Taxpayer did not show that the DRA incorrectly assessed the BPT liability. The board reaches this conclusion based on the following factors.

1) RSA 21-J:28-b (Supp. 1996) provides that the board "may grant such relief as may be just and equitable ***." Justice and equity do not require a reversal of the DRA's determination in this case. This conclusion is based on the factors discussed below. A major factor is that the Taxpayer played fast and loose with the federal and state tax returns. Having made its decision about completing the returns, the Taxpayer cannot now complain about the DRA's actions. The Taxpayer was the one who called the $105,000 rent on the checks, in its books and on its federal tax return. Having been caught calling it

rent when in fact it was not all rent, the Taxpayer now asks the board to exercise its jurisdiction to help the Taxpayer avoid tax liability. The board will not do so, concluding to do so would require approving the Taxpayer's conduct.

Recall that on both the federal and state form the Taxpayer declared under the penalties of perjury that the information in the returns was true. The information was patently untrue, and the board will not now allow the Taxpayer to change what the Taxpayer had previously sworn was true. Completion of tax returns is not a game but is an obligation that the Taxpayer did not take seriously.

Even the Taxpayer's accountant admitted that the goal was simply to get a deduction. Businesses often structure transactions to reduce tax liability. Provided such structuring reflects reality and is not a scam, taxpayers are entitled to the benefit of such structures. However, the Taxpayer did not do this.

The Taxpayer asserted it does not matter what a payment was really for as long as it can be deducted somehow. In this case, the Taxpayer had legitimate ways to avoid BPT liability such as paying the MacDonalds compensation based solely on the services each rendered. As discussed below, the Taxpayer did not do this.

While not a deciding factor, the board also notes that the Partnership return was similarly filled out without due consideration to reality. The MacDonalds, who own the Taxpayer, are the only partners in the Partnership.

On the Partnership return, the MacDonalds deducted the full $105,000 as services rendered by the MacDonalds to the Partnership. Because the Partnership was only a real estate holding entity, it is clear the $105,000 was primarily a return on the real estate and was not a payment for services. While not directly at issue here, this activity by a related entity controlled by the MacDonalds confirms that the MacDonalds have not acted with complete candor but rather have acted simply to minimize taxation even if not entitled to such tax treatment.

2) The Taxpayer argued the board should follow Langer v. Commissioner, 59 T.C.M. 740 (1990), but the board will not. The Langer decision is not controlling on the board. Our enabling statute speaks of equity and justice, and the board has concluded equity and justice do not warrant granting this Taxpayer relief. Additionally, the DRA supplied the board with other tax court cases that contradict Langer. See also Bravenec, Federal Taxation of S Corporations and Shareholders § 3.3.3 (2nd ed. 1988) (taxpayers generally not successful in after-the-audit assertion that a disputed item was actually compensation). The DRA certainly may look at the substance of an item during an audit. But taxpayers should not be allowed to file a false return on the assumption the return can be revised if challenged in an audit. Such an approach would encourage inaccurate returns.

3) In situations involving family controlled corporations, as was the case here, claims of compensation must be closely scrutinized lest the payments actually be dividends disguised as compensation. Seven Canal Place Corp. v. Commissioner, 332 F.2d 899, 900 (2nd Cir. 1964).

4) The payments of $35,000 to each of the shareholders according to their one-third interests in the Taxpayer appear to be dividends even though services were rendered to the Taxpayer by the MacDonalds. The Taxpayer

informed the board that the MacDonalds worked in the dealership. One MacDonald worked full-time, and the other two worked part-time. Yet, the 1990 payments were not based on the amount of time dedicated to the dealership but were based on the stock ownership, i.e., each MacDonald received one-third of the $105,000. Payments based on stock ownership, rather than services rendered, indicate a dividend rather than compensation. Kennedy v. Commissioner, 671 F.2d 167, 175 (Sixth Cir. 1982); see also IRS Regs. § 301 (a) (1990) (dividend is a payment "with respect to [taxpayer's] stock ***.); Bittken and Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 98.05[1] (1994) (dividend payment to shareholder as shareholder).

5) To constitute compensation, the payments must be "in fact payment purely for services." IRS Regs. § 1.162-7 (1990). The Taxpayer did not show the $75,000 met this test. First, the Taxpayer presented no facts (see above IRS Regs § 1.162-7 "in fact") to prove the actual work performed. The Taxpayer's representative presented a calculated amount of hours without any supporting testimony or other evidence. We find this evidence insufficient. Second, as discussed above, the payments were based on percent ownership, raising the question of whether the $75,000 was paid "purely for services."

6) When the payments were made to the MacDonalds, the payments were intended to be for rent. The payments were not intended to be for compensation. The board does not see how the Taxpayer can legitimately now argue that the Taxpayer's original intent can be changed simply to avoid tax liability.

The DRA submitted tax court decisions supporting the board's own conclusion. In Columbia Steak House II, Inc., 41 T.C.M. 1163 (1981), the court concluded that even though valuable services were provided by the individuals to the corporation, the corporation's intent upon making a payment was the controlling factor. The court stated that the determination of whether the intent was compensation or some other distribution was a factual question. Id. at 1167. The record in the instant case is clear that

compensation was not intended when payments were made to the MacDonalds. See also Roehl Construction Company, Inc. v. Commissioner, 17 T.C. 1037, 1040-41 (1951) (while substance must control form, when the facts show the intended nature of a distribution, the taxpayer should not be allowed to retrospectively change the intent of such distribution). In Paula Construction Co. v. Commissioner, 58 T.C. 1055, 1058-61 (1972), the tax court similarly concluded that even though individuals performed services that could have been compensable and thus deductible, such factors do not establish that the payments were intended as compensation. Thus, if the payments were not initially intended as compensation, the fact that compensation may have been reasonable and earned does not alter the intention of the distribution.

The MacDonalds may have provided valuable services to the corporation that were compensable, but when the checks were written, there was no intent that the payments be compensation.

We also note that had the Taxpayer intended the payments to be compensation, the Taxpayer would have been required to send W-2 forms to the MacDonalds, would have been required to withhold taxes and pay the employer's share of FICA and medicare. Additionally, the compensation might have entered into the Taxpayer's worker's compensation payment or unemployment compensation payment. In other words, the compensation issue cannot be viewed in isolation, but rather it must be viewed as part of the entire taxing and business-regulations system.

Conclusion

The above analysis requires a denial of the appeal.

Having denied the Taxpayer's appeal, we also deny the Taxpayer's request for costs.

Findings of Fact and Rulings of Law

In these responses, "neither granted nor denied" generally means one of the following:

a. the request contained multiple requests for which a consistent response could not be given;

b. the request contained words, especially adjectives or adverbs, that made the request so broad or specific that the request could not be granted or denied;

c. the request contained matters not in evidence or not sufficiently supported to grant or deny;

d. the request was irrelevant; or

e. the request is specifically addressed in the decision.

Findings of Fact

1. Granted.

2. Granted.

3. Granted.

4. Granted.

5. Granted.

6. Granted.

7. Granted.

Rulings of Law

1. Granted.

2. Granted.

3. Granted.

4. Granted.

5. Granted.

Rehearing

A motion for rehearing, reconsideration or clarification (collectively "rehearing motion") of this decision must be filed within thirty (30) days of the clerk's date below, not the date this decision is received. RSA 541:3;

TAX 201.37. The rehearing motion must state with specificity all of the reasons supporting the request. RSA 541:4; TAX 201.37(b). A rehearing motion is granted only if the moving party establishes: 1) the decision needs clarification; or 2) based on the evidence and arguments submitted to the board, the board's decision was erroneous in fact or in law. Thus, new evidence and new arguments are only allowed in very limited circumstances as stated in board rule TAX 201.37(e). Filing a rehearing motion is a prerequisite for appealing to the supreme court, and the grounds on appeal are limited to those stated in the rehearing motion. RSA 541:6. Generally, if the board denies the rehearing motion, an appeal to the supreme court must be filed within thirty (30) days of the date on the board's denial.

SO ORDERED.

BOARD OF TAX AND LAND APPEALS

Ignatius MacLellan, Esq., Member

Michele E. LeBrun, Member

Douglas S. Ricard, Member

Certification

I hereby certify a copy of the foregoing decision has been mailed this date, postage prepaid, to Robert L. Johnson, Agent for MacDonald Motors, Inc., Taxpayer; and the Department of Revenue Administration.

Date: November 18, 1997

Valerie B. Lanigan, Clerk

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ORDER

This order relates to the "Department of Revenue Administration's" (DRA) July 16, 1997 motion for default. The board declares the "Taxpayer" in default, pursuant to TAX 209.02(d), and orders the Taxpayer to complete and file with the board within 10 days an updated appeal form (enclosed), copying the DRA. The updated appeal form was amended to include, pursuant to TAX 209.02(c), a section requiring specificity of the reasons the Taxpayer intends to rely on in presenting their appeal.

If the Taxpayer fails to respond to this order within ten (10) days from the clerk's date below, the board shall dismiss the appeal.

SO ORDERED.

BOARD OF TAX AND LAND APPEALS

Valerie B. Lanigan, Clerk

CERTIFICATION

I hereby certify that the foregoing order has been mailed postage prepaid, to Robert L. Johnson, Representative for the Taxpayer; and John F.

Hayes, Assistant Revenue Counsel for the Department of Revenue Administration.

Dated: July 23, 1997

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______________________________________ Valerie B. Lanigan, Clerk