



Don't Get Too Personal (Service Corporation That Is)
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Personal Service Corporations

In honor of the fact that this week w(A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, *accounting*, actuarial science, performing arts, or consulting, and

(B) substantially all of the stock of which (by value) is held * * * by —

(i) employees performing services for such corporation * * * e come upon the due date of our calendar year end corporation, we look at the issue of what is a personal service corporation—a question posed in the case of *Ron Lykins, Inc. v. Commissioner*, TC Memorandum 2006-35 and answered in a taxpayer friendly manner in that case.

As those of us who were in practice in the 1980s remember, Congress in that decade decided that certain C corporations should not be able to take advantage of the lower progressive corporate tax brackets. The disadvantaged corporations are those that are “qualified personal service corporations” as referenced at IRC §11(b)(2).

The actual definition of a personal service corporation is found at §448(d)(2) which tells us a personal service corporation is a C corporation in which:

448(d)(2) QUALIFIED PERSONAL SERVICE CORPORATION. --The term "qualified personal service corporation" means any corporation --

448(d)(2)(A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

448(d)(2)(B) substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corporations, or qualified personal service corporations not described in paragraph (2) or (3) of subsection (a)) by --

448(d)(2)(B)(i) employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),

448(d)(2)(B)(ii) retired employees who had performed such services for such corporation,

448(d)(2)(B)(iii) the estate of any individual described in clause (i) or (ii), or

448(d)(2)(B)(iv) any other person who acquired such stock by reason of the death of an individual described in clause (i) or (ii) (but only for the 2-year period beginning on the date of the death of such individual).

To the extent provided in regulations which shall be prescribed by the Secretary, indirect holdings through a trust shall be taken into account under subparagraph (B).

Now, you might wonder what in the heck the definition is doing all the way over the in 400 area of the Internal Revenue Code. Well, what Congress did was "borrow" the definition that was used to allow certain C corporations with gross receipts in excess of \$5 million to continue to report on the cash basis of accounting.

Regulation §1.448-1T(e)(4) has the ownership test and Regulation §1.448-1T(e)(5) contains the test for the functions. See the regulation in the appendix.

In the case in question, though, the issue of applying the functional test was faced with an interesting twist that we'll consider.

Ron Lykins, Inc. vs. Commissioner Tax Court Opinion

Ronald G. Lykins, *pro se*; Stephen J. Neubeck, for respondent.

MEMORANDUM OPINION

HOLMES, Judge: Ron Lykins, Inc., is a well-established firm in central Ohio that for many years sold both accounting and financial advice to its clients. In 2000, the sole owner of the company — Ronald Lykins — split off the financial advisory business to a new company. This left Lykins Inc. selling nothing but accounting services, and the Commissioner argues that this made it a “qualified personal services corporation.” If he is right, the Code would tax Lykins Inc. at a flat rate of 35 percent; if he isn't, its rate would be lower.

Background

Ronald Lykins is a well-educated man, with an M.B.A. and Ph.D.; he is also a C.P.A. He started preparing tax returns in 1969 to supplement his income, and when he opened an accounting practice it quickly came to focus on tax preparation and advice. His clients began trusting him for financial and investment advice as well, and his business steadily grew. He incorporated it as Ron Lykins, Inc. in 1980, and Lykins Inc. has ever since filed tax returns as a Subchapter C corporation. The financial and investment services side of the business took more and more of his time, and Lykins was advised by his lawyer that it would make sense for him to segregate the tax preparation side of the business from the investment advice side — should Lykins wish to retire, he was told, he would be able to market his businesses to a wider variety of buyers if they were separate.

In 2000, he took that advice and formed Lykins Financial Group, LLC, a limited liability company under Ohio law. Lykins Inc. continued to offer tax services, but Lykins Financial now began offering all the financial and investment services. Lykins himself was the sole owner of both companies. Fully separating the companies proved difficult. Segregating their income was easy — in 2000, Lykins Financial's income came exclusively in the form of commissions on the sale of securities and investment advice; Lykins Inc.'s income came exclusively from fees that it charged for tax preparation and advice. But the formation of Lykins Financial had led to few physical changes. The firms shared the same office space, and had the same address, same phone number, same copying machine and fax, same employee manual, and even the same coffee machine. This all made segregating the two firms' expenses quite difficult. The firms also had no written agreement defining whose employees were whose, and while some employees worked only on financial services and investments and some worked only on tax preparation, there were also some who worked on both. Further complicating the situation, Lykins Inc. provided overhead services such as reception and payroll to Lykins Financial. It also continued to pay all the rent on the shared office space, and all the employees' wages and payroll taxes. Lykins credibly testified that he gave up on dividing expenses in a more sophisticated way, and simply allocated them between the two companies based on his own estimate of each firm's share of their combined total hours worked.

Lykins Inc. and Lykins Financial did file separate corporate tax returns. The Commissioner audited Lykins Inc., and issued it a notice of deficiency for 1999 and 2000 after concluding that the firm had become a “qualified personal services corporation” (QPSC). The Commissioner later conceded that Lykins Inc. was not a QPSC in 1999, but stood firm in his belief that it became one in 2000. Trial was held in Ohio, where Lykins

Inc. has always had its principal place of business.

Discussion

The Code's various definitions of personal services corporations date back to a time when the top tax rate for individual income was much higher than the rate for corporations. This gave professionals an incentive to incorporate their practices to win the benefits available both to employees¹ or corporations.² Identifying certain personal services corporations as “qualified professional services corporations,” and taxing them at a flat rate of 35 percent, see sec. 11(b)(2),³ was Congress's way to reduce the incentive for professionals to shelter part of their income in a corporate form with a lower marginal rate. As the House Ways and Means Committee explained:

The personal service income of corporations owned by its employees is taxed to the employee-owners at the individual graduated rates as it is paid out as salary. The committee believes that it is inappropriate to allow the retained earnings to be taxed at the lower corporate graduated rates.

H. Rept. 100-391 (II), U.S.C.C.A.N. 2313-712 (1987).

Section 448(d)(2) defines QPSCs as corporations

(A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, *accounting*, actuarial science, performing arts, or consulting, and

(B) substantially all of the stock of which (by value) is held * * * by —

(i) employees performing services for such corporation * * *

(Emphasis added).

This definition sets up two tests—an ownership test and a function test. Deciding whether Lykins Inc. meets the ownership test is easy. A regulation defines “substantially all” of a corporation's stock to mean “an amount equal to or greater than 95 percent.” Sec. 1.448-1T(e)(4)(i) and (ii), Temporary Income Tax Regs., 52 Fed. Reg. 22768, 22770 (June 16, 1987), Lykins is the sole shareholder of Lykins Inc., and he is an employee because he performs more than a *de minimis* amount of accounting services for the firm, sec. 1.448-1T(e)(5)(i) and (ii), Temporary Income Tax Regs., 52 Fed. Reg. 22770 (June 16, 1987), so Lykins Inc. passes.

A second regulation—the key one for this case—tells us that “substantially all” of a firm's functions are in one or another of the professions snagged in the QPSC net:

only if 95 percent or more of the *time spent by employees of the corporation, serving in their capacity as such*, is devoted to the performance of services in a qualifying field. For purposes of determining whether this 95 percent test is satisfied, the performance of any activity incident to the actual performance of services in a qualifying field is considered the performance of services in that field. Activities incident to the performance of services in a qualifying field include the supervision of employees engaged in directly providing services to clients, and the performance of administrative and support services incident to such activities. * * *

Sec. 1.448-1T(e)(4)(i), Temporary Income Tax Regs, 52 Fed. Reg. 22766 (June 16, 1987) (emphasis added).

Lykins's decision to split his business thus threatens to ensnare him: The Code itself lists “accounting” as one of the qualifying fields, and the regulations carefully distinguish investment advice sold for a fee from investment advice sold incident to a brokerage service producing commissions.⁴ Lykins Financial, whose income was entirely in the form of commissions was not, under the regulation, selling services in a qualifying field. Lykins Inc. was.

The Commissioner argues that when Lykins Inc. hived off its investment business from its accounting services, it necessarily left behind only the qualifying field of accounting. He asserts that if employees generated commission income, they were Lykins Financial employees. He backs up his argument by pointing to Lykins Inc.'s allocation of payroll costs to Lykins Financial, and Lykins Financial's reimbursement of those costs as proof that those employees who were performing investment services were employees of Lykins Financial.

An unstated assumption of the Commissioner's position is that someone is the employee only of the firm he's producing income for. There is no caselaw interpreting the regulation's phrase “employees of the corporation, serving in their capacity as such,” sec. 1.448-1T(e)(4)(i), Temporary Income Tax Regs., and the Commissioner's argument is at least plausible. But “employer” and “employee” are legal terms with a rich history of construction in the many other places that they are found in Federal law. The Supreme Court has, moreover, laid down as a general rule that “when Congress has used the term ‘employee’ without defining it, we have concluded that Congress intended to describe the conventional master-servant relationship as understood by common-law agency doctrine;” see also *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 322-323 (1992). The Commissioner has likewise adopted common law rules to distinguish employees from independent contractors. See Rev. Rul. 87-41, 1987-1 C.B. 296; *Darden*, 503 U.S. at 324 (citing that revenue ruling with approval); *Clackamas Gastroenterology Associates, P.C. v. Wells*, 538 U.S. 440, 448 (2003)(calling the common law element of control the “principal guidepost”).

So, in the absence of a different definition in either the statute or the regulation, we think that the answer to the question “Which workers were Lykins Inc.'s employees?” should be found by applying common law principles. At common law, the key criterion is one of control—an employer is one with the right to control the manner and means by which an employee does his chores. See Rev. Rul. 87-41, 1987-1 C.B. 296. And the common law recognizes that “a person may be the servant of two masters * * * at one time as to one act, if the service to one does not involve the abandonment of the service to the other.” 2 Restatement Agency 2d, sec. 226 (1958). There is even an “inference” (by which the Restatement seems to mean a rebuttable presumption) that “the actor remains in his general employment so long as, by the service rendered another, he is performing the business entrusted to him by the general employer. There is no inference that because the general employer has permitted a division of control, he has surrendered it.” *Id.* sec. 227, comment b.

This presumption of continued employment and this recognition that in law—if not in life, see Matthew 6:24—a man can serve two masters, speak directly to this case. Lykins's testimony (which we specifically find credible on this point) and the exhibits he introduced, reinforce rather than rebut the presumption. They show that those who worked at Lykins Financial continued to receive paychecks drawn on Lykins Inc., continued to receive benefits provided by Lykins Inc., and continued to have their Social Security tax paid for by Lykins Inc. They had worked at Lykins Inc. at the start of 2000, and those working on financial services during the year were told to do so by Lykins Inc. Lykins Financial even reimbursed Lykins Inc. for their wages, taking a deduction; Lykins Inc. reported those reimbursements as income.

Simply allocating the costs of Lykins Inc. employees to Lykins Financial does not make them Lykins Financial employees. And, while the line between Lykins Inc. and Lykins Financial was clear only in its blurriness, we conclude on the peculiar facts of this case—especially the fact that before Lykins Financial

was formed, all these employees were Lykins Inc. employees, and continued to have their wages, benefits, and taxes paid by Lykins Inc. —that they continued to be Lykins Inc. employees throughout the year.

This makes deciding the case easy. Lykins Inc. and the Commissioner stipulated to a breakdown of Lykins Inc.'s employees' hours into two categories: hours spent on accounting and consulting services, and hours spent on investment services. The exhibit shows that 80.53 percent of employee hours in 2000 were spent on accounting services, while 19.47 percent of employee hours were spent on investment services.

Because 80.53 percent is less than 95 percent, Lykins Inc. was not a QPSC in 2000, and so not subject to tax at the QPSC rate used in the notice of deficiency. The Commissioner's assertion of a penalty disappears with that deficiency, and so

Decision will be entered for petitioner.

¹ As employees of a corporation, professionals could avail themselves of group term life insurance, medical reimbursement plans, death benefits, and a more generous retirement plan than if they remained self-employed. See Phillips, et al., "Origins of Tax Law: The History of the Personal Service Corporation", 40 Wash. & Lee L. Rev. 433, 434-435 (1983); see also *Chickasaw Ambulance Serv. Inc. v. United States*, 1999 WL 33656862 (N.D. Iowa).

² See sec. 469(a)(1)-(2), which prevent personal service corporations from deducting passive activity losses on the same terms as other corporations.

³ Unless otherwise stated, section references are to the Internal Revenue Code and regulations as amended and in effect for 2000.

⁴ Sec. 1.448-1T(3)(4)(iv)(B), *Examples* (4),(5),(10), Temporary Income Tax Regs. 22767 (June 16, 1987).

Regulation 1.448-1T

§1.448-1T. Limitation on the use of the cash receipts and disbursements method of accounting (temporary)

(a) Limitation on accounting method

(1) *In general.* —This section prescribes regulations under section 448 relating to the limitation on the use of the cash receipts and disbursements method of accounting (the cash method) by certain taxpayers.

(2) *Limitation rule.* —Except as otherwise provided in this section, the computation of taxable income using the cash method is prohibited in the case of a —

- (i) C corporation,
- (ii) Partnership with a C corporation as a partner, or
- (iii) Tax shelter.

A partnership is described in paragraph (a)(2)(ii) of this section, if the partnership has a C corporation as a partner at any time during the partnership's taxable year beginning after December 31, 1986.

(3) *Meaning of C corporation.* —For purposes of this section, the term “C corporation” includes any corporation that is not an S corporation. For example, a regulated investment company (as defined in section 851) or a real estate investment trust (as defined in section 856) is a C corporation for purposes of this section. In addition, a trust subject to tax under section 511(b) shall be treated, for purposes of this section, as a C corporation, but only with respect to the portion of its activities that constitute an unrelated trade or business. Similarly, for purposes of this section, a corporation that is exempt from federal income taxes under section 501(a) shall be treated as a C corporation only with respect to the portion of its activities that constitute an unrelated trade or business. Moreover, for purposes of determining whether a partnership has a C corporation as a partner, any partnership described in paragraph (a)(2)(ii) of this section is treated as C corporation. Thus, if partnership ABC has a partner that is a partnership with a C corporation, then, for purposes of this section, partnership ABC is treated as a partnership with a C corporation partner.

(4) *Treatment of a combination of methods.* —For purposes of this section, the use of a method of accounting that records some, but not all, items on the cash method shall be considered the use of the cash method. Thus, a C corporation that uses a combination of accounting methods including the use of the cash method is subject to this section.

(b) Tax shelter defined

(1) *In general.* —For purposes of this section, the term “tax shelter” means any —

- (i) Enterprise (other than a C corporation) if at any time (including taxable years beginning before January 1, 1987) interests in such enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale,

(ii) Syndicate (within the meaning of paragraph (b)(2) of this section), or

(iii) Tax shelter within the meaning of section 6662(d)(2)(C).

(2) *Requirement of registration.* —For purposes of paragraph (b)(1)(i) of this section, an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to register the offering would result in a violation of the applicable federal or state law (regardless of whether the offering is in fact registered). In addition, an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable federal or state law (regardless of whether the notice is in fact filed).

(3) *Meaning of syndicate.* —For purposes of paragraph (b)(1)(ii) of this section, the term “syndicate” means a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during the taxable year (for taxable years beginning after December 31, 1986) are allocated to limited partners or limited entrepreneurs. For purposes of this paragraph (b)(3), the term “limited entrepreneur” has the same meaning given such term in section 464(e)(2). In addition, in determining whether an interest in a partnership is held by a limited partner, or an interest in an entity or enterprise is held by a limited entrepreneur, section 464(c)(2) shall apply in the case of the trade or business of farming (as defined in paragraph (d)(2) of this section), and section 1256(e)(3)(C) shall apply in any other case. Moreover, for purposes of this paragraph (b)(3), the losses of a partnership, entity, or enterprise (the enterprise) means the excess of the deductions allowable to the enterprise over the amount of income recognized by such enterprise under the enterprise's method of accounting used for federal income tax purposes (determined without regard to this section). For this purpose, gains or losses from the sale of capital assets or section 1221(2) assets are not taken into account.

(4) *Presumed tax avoidance.* —For purposes of paragraph (b)(1)(iii) of this section, marketed arrangements in which persons carry on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons use borrowed funds to prepay a substantial portion of their farming expenses (e.g., payment for farm supplies that will not be used or consumed until a taxable year subsequent to the taxable year of payment).

(5) *Taxable year tax shelter must change accounting method.* —A partnership, entity, or enterprise that is a tax shelter must change from the cash method for the later of (i) the first taxable year beginning after December 31, 1986, or (ii) the taxable year that such partnership, entity, or enterprise becomes a tax shelter.

(c) *Effect of section 448 on other provisions.* —Nothing in section 448 shall have any effect on the application of any other provision of law that would otherwise limit the use of the cash method, and no inference shall be drawn from section 448 with respect to the application of any such provision. For example, nothing in section 448 affects the requirement of section 447 that certain corporations must use an accrual method of accounting in computing taxable income from farming, or the requirement of §1.446-1(c)(2) that an accrual method be used with regard to purchases and sales of inventory. Similarly, nothing in section 448 affects the authority of the Commissioner under section 446(b) to require the use of an accounting method that clearly reflects income, or the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. For example, a taxpayer using the cash method may be required to change to an accrual method of accounting under section 446(b) because such method clearly reflects that taxpayer's income, even though the taxpayer is not prohibited by section 448 from using the cash method. Similarly, a taxpayer using an accrual method of

accounting that is not prohibited by section 448 from using the cash method may not change to the cash method unless the taxpayer secures the consent of the Commissioner under section 446(e), and, in the opinion of the Commissioner, the use of the cash method clearly reflects that taxpayer's income under section 446(b).

(d) Exception for farming business

(1) *In general.* —Except in the case of a tax shelter, this section shall not apply to any farming business. A taxpayer engaged in a farming business and a separate nonfarming business is not prohibited by this section from using the cash method with respect to the farming business, even though the taxpayer may be prohibited by this section from using the cash method with respect to the nonfarming business.

(2) *Meaning of farming business.* —For purposes of paragraph (d) of this section, the term “farming business” means —

(i) The trade or business of farming as defined in section 263A(e)(4) (including the operation of a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees), or

(ii) The raising, harvesting, or growing of trees described in section 263A(c)(5) (relating to trees raised, harvested, or grown by the taxpayer other than trees described in paragraph (d)(2)(i) of this section).

Thus, for purposes of this section, the term “farming business” includes the raising of timber. For purposes of this section, the term “farming business” does not include the processing of commodities or products beyond those activities normally incident to the growing, raising or harvesting of such products. For example, assume that a C corporation taxpayer is in the business of growing and harvesting wheat and other grains. The taxpayer processes the harvested grains to produce breads, cereals, and similar food products which it sells to customers in the course of its business. Although the taxpayer is in the farming business with respect to the growing and harvesting of grain, the taxpayer is not in the farming business with respect to the processing of such grains to produce food products which the taxpayer sells to customers. Similarly, assume that a taxpayer is in the business of raising poultry or other livestock. The taxpayer uses the livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged or canned for sale to customers. Although the taxpayer is in the farming business with respect to the raising of livestock, the taxpayer is not in the farming business with respect to the meat processing operation. However, under this section the term “farming business” does include processing activities which are normally incident to the growing, raising or harvesting of agricultural products. For example, assume a taxpayer is in the business of growing fruits and vegetables. When the fruits and vegetables are ready to be harvested, the taxpayer picks, washes, inspects, and packages the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the business of farming with respect to the growing of fruits and vegetables, and the processing activities incident to the harvest.

(e) Exception for qualified personal service corporation

(1) *In general.* —Except in the case of a tax shelter, this section does not apply to a qualified personal service corporation.

(2) *Certain treatment for qualified personal service corporation.* —For purposes of paragraph (a)(2)(ii) of this section (relating to whether a partnership has a C corporation as a partner), a qualified

personal service corporation shall be treated as an individual.

(3) *Meaning of qualified personal service corporation.* —For purposes of this section, the term “qualified personal service corporation” means any corporation that meets —

- (i) The function test of paragraph (e)(4) of this section, and
- (ii) The ownership test of paragraph (e)(5) of this section.

(4) *Function test*

(i) *In general.* —A corporation meets the function test if substantially all the corporation's activities for a taxable year involve the performance of services in one or more of the following fields —

- (A) Health,
- (B) Law,
- (C) Engineering (including surveying and mapping),
- (D) Architecture,
- (E) Accounting,
- (F) Actuarial science,
- (G) Performing arts, or
- (H) Consulting.

Substantially all of the activities of a corporation are involved in the performance of services in any field described in the preceding sentence (a qualifying field), only if 95 percent or more of the time spent by employees of the corporation, serving in their capacity as such, is devoted to the performance of services in a qualifying field. For purposes of determining whether this 95 percent test is satisfied, the performance of any activity incident to the actual performance of services in a qualifying field is considered the performance of services in that field. Activities incident to the performance of services in a qualifying field include the supervision of employees engaged in directly providing services to clients, and the performance of administrative and support services incident to such activities.

(ii) *Meaning of services performed in the field of health.* —For purposes of paragraph (e)(4)(i)(A) of this section, the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar health-care professionals. The performance of services in the field of health does not include the provisions of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers.

(iii) *Meaning of services performed in the field of performing arts.* —For purposes of paragraph

(e)(4)(i)(G) of this section, the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performances of such artists to members of the public (*e.g.*, employees of a radio station that broadcasts the performances of musicians and singers). Finally, the performance of services in the field of the performing arts does not include the provision of services by athletes.

(iv) Meaning of services performed in the field of consulting

(A) *In general.* —For purposes of paragraph (e)(4)(i)(H) of this section, the performance of services in the field of consulting means the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services. For purposes of the preceding sentence, the determination of whether a person's services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (*e.g.*, whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect).

(B) *Examples.* —The following examples illustrate the provisions of paragraph (e)(4)(iv)(A) of this section. The examples do not address all types of services that may or may not qualify as consulting. The determination of whether activities not specifically addressed in the examples qualify as consulting shall be made by comparing the service activities in question to the types of service activities discussed in the examples. With respect to a corporation which performs services which qualify as consulting under this section, and other services which do not qualify as consulting, see paragraph (e)(4)(i) of this section which requires that substantially all of the corporation's activities involve the performance of services in a qualifying field.

Example (1). A taxpayer is in the business of providing economic analyses and forecasts of business prospects for its clients. Based on these analyses and forecasts, the taxpayer advises its clients on their business activities. For example, the taxpayer may analyze the economic conditions and outlook for a particular industry which a client is considering entering. The taxpayer will then make recommendations and advise the client on the prospects of entering the industry, as well as on other matters regarding the client's activities in such industry. The taxpayer provides similar services to other clients, involving, for example, economic analyses and evaluations of business prospects in different areas of the United States or in other countries, or economic analyses of overall economic trends and the provision of advice based on these analyses and evaluations. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example (2). A taxpayer is in the business of providing services that consist of determining a client's electronic data processing needs. The taxpayer will study and examine the client's business, focusing on the types of data and information relevant to the client and the needs of the client's employees for access to this information. The taxpayer will then make recommendations regarding the design and implementation of data processing systems intended to meet the needs of the client. The taxpayer does not, however, provide the client with additional computer

programming services distinct from the recommendations made by the taxpayer with respect to the design and implementation of the client's data processing systems. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example (3). A taxpayer is in the business of providing services that consist of determining a client's management and business structure needs. The taxpayer will study the client's organization, including, for example, the departments assigned to perform specific functions, lines of authority in the managerial hierarchy, personnel hiring, job responsibility, and personnel evaluations and compensation. Based on the study, the taxpayer will then advise the client on changes in the client's management and business structure, including, for example, the restructuring of the client's departmental systems or its lines of managerial authority. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example (4). A taxpayer is in the business of providing financial planning services. The taxpayer will study a particular client's financial situation, including, for example, the client's present income, savings and investments, and anticipated future economic and financial needs. Based on this study, the taxpayer will then assist the client in making decisions and plans regarding the client's financial activities. Such financial planning includes the design of a personal budget to assist the client in monitoring the client's financial situation, the adoption of investment strategies tailored to the client's needs, and other similar services. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example (5). A taxpayer is in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. The taxpayer provides its clients with economic analyses and forecasts of conditions in various industries and businesses. Based on these analyses, the taxpayer makes recommendations regarding transactions in securities and commodities. Clients place orders with the taxpayer to trade securities or commodities based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the trade orders. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the execution of trade orders for its clients).

Example (6). A taxpayer is in the business of studying a client's needs regarding its data processing facilities and making recommendations to the client regarding the design and implementation of data processing systems. The client will then order computers and other data processing equipment through the taxpayer based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the equipment orders made by the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of sales services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the execution of equipment orders for its clients).

Example (7). A taxpayer is in the business of assisting businesses in meeting their personnel requirements by referring job applicants to employers with hiring needs in a particular area. The taxpayer may be informed by potential employers of their need for job applicants, or, alternatively, the taxpayer may become aware of the client's personnel requirements after the taxpayer studies and examines the client's management and business structure. The taxpayer's compensation for its services is typically based on the job applicants, referred by the taxpayer to

the clients, who accept employment positions with the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is involved in the performance of services economically similar to brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the hiring of a job applicant by the client).

Example (8). The facts are the same as in example (7), except that the taxpayer's clients are individuals who use the services of the taxpayer to obtain employment positions. The taxpayer is typically compensated by its clients who obtain employment as a result of the taxpayer's services. For the reasons set forth in example (7), the taxpayer is not considered to be engaged in the performance of services in the field of consulting.

Example (9). A taxpayer is in the business of assisting clients in placing advertisements for their goods and services. The taxpayer analyzes the conditions and trends in the client's particular industry, and then makes recommendations to the client regarding the types of advertisements which should be placed by the client and the various types of advertising media (e.g., radio, television, magazines, etc.) which should be used by the client. The client will then purchase, through the taxpayer, advertisements in various media based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the particular orders for advertisements which the client makes. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of services economically similar to brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the placing of advertisements by clients).

Example (10). A taxpayer is in the business of selling insurance (including life and casualty insurance), annuities, and other similar insurance products to various individual and business clients. The taxpayer will study the particular client's financial situation, including, for example, the client's present income, savings and investments, business and personal insurance risks, and anticipated future economic and financial needs. Based on this study, the taxpayer will then make recommendations to the client regarding the desirability of various insurance products. The client will then purchase these various insurance products through the taxpayer. The taxpayer's compensation for its services is typically based on the purchases made by the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of brokerage or sales services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the purchase of insurance products by its clients).

(5) Ownership test

(i) In general. —A corporation meets the ownership test, if at all times during the taxable year, substantially all the corporation's stock, by value, is held, directly or indirectly, by —

(A) Employees performing services for such corporation in connection with activities involving a field referred to in paragraph (e)(4) of this section,

(B) Retired employees who had performed such services for such corporation,

(C) The estate of any individual described in paragraph (e)(5)(i)(A) or (B), or

(D) Any other person who acquired such stock by reason of the death of an individual described in paragraph (e)(5)(i)(A) or (B), but only for the 2-year period beginning on the date of the death of such individual.

For purposes of this paragraph (e)(5), the term “substantially all” means an amount equal to or greater than 95 percent.

(ii) *Definition of employee.* —For purposes of the ownership test of this paragraph (e)(5), a person shall not be considered an employee of a corporation unless the services performed by that person for such corporation, based on the facts and circumstances, are more than de minimis. In addition, a person who is an employee of a corporation shall not be treated as an employee of another corporation merely by reason of the employer corporation and the other corporation being members of the same affiliated group or otherwise related.

(iii) *Attribution rules.* —For purposes of this paragraph (e)(5), 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 other arrangement or type of ownership shall constitute indirect ownership of a corporation's stock for purposes of this paragraph (e)(5). Moreover, stock of a corporation held by a trust is considered held by a person if, and to the extent, such person is treated under subpart E, part I, subchapter J, chapter I of the Code as the owner of the portion of the trust that consists of such stock.

(iv) *Disregard of community property laws.* —For purposes of this paragraph (e)(5), community property laws shall be disregarded. Thus, in determining the stock ownership of a corporation, stock owned by a spouse solely by reason of community property laws shall be treated as owned by the other spouse.

(v) *Treatment of certain stock plans.* —For purposes of this paragraph (e)(5), stock held by a plan described in section 401(a) that is exempt from tax under section 501(a) shall be treated as held by an employee described in paragraph (e)(5)(i)(A) of this section.

(vi) *Special election for certain affiliated groups.* —For purposes of determining whether the stock ownership test of this paragraph (e)(5) has been met, at the election of the common parent of an affiliated group (within the meaning of section 1504(a)), all members of such group shall be treated as one taxpayer if substantially all (within the meaning of paragraph (e)(4)(i) of this section) the activities of all such members (in the aggregate) are in the same field described in paragraph (e)(4)(i)(A)-(H) of this section. For rules relating to the making of the election, see 26 CFR 5h.5 (temporary regulations relating to elections under the Tax Reform Act of 1986).

(vii) *Examples.* —The following examples illustrate the provisions of paragraph (e) of this section:

Example (1). (i) X, a C corporation, is engaged in the business of providing accounting services to its clients. These services consist of the preparation of audit and financial statements and the preparation of tax returns. For purposes of section 448, such services consist of the performance of services in the field of accounting. In addition, for purposes of section 448, the supervision of employees directly preparing the statements and returns, and the performance of all administrative and support services incident to such activities (including secretarial, janitorial, purchasing, personnel, security, and payroll services) are the performance of services in the field of accounting.

(ii) In addition, X owns and leases a portion of an office building. For purposes of this section, the following types of activities undertaken by the employees of X shall be considered as the performance of services in a field other than the field of accounting: (A) services directly relating to the leasing activities, e.g., time spent in leasing and maintaining the leased portion of the building; (B) supervision of employees engaged in directly providing services in the leasing activity; and (C) all administrative and support services incurred incident to services described in (A) and (B). The leasing activities of X are considered the performance of services in a field other than the field of accounting, regardless of whether such leasing activities constitute a trade or business under the Code. If the employees of X spend 95% or more of their time in the performance of services in the field of accounting, X satisfies the function test of paragraph (e)(4) of this section.

Example (2). Assume that Y, a C corporation, meets the function test of paragraph (e)(4) of this section. Assume further that all the employees of Y are performing services for Y in a qualifying field as defined in paragraph (e)(4) of this section. P, a partnership, owns 40%, by value, of the stock of Y. The remaining 60% of the stock of Y is owned directly by employees of Y. Employees of Y have an aggregate interest of 90% in the capital and profits of P. Thus, 96% of the stock of Y is held directly, or indirectly, by employees of Y performing services in a qualifying field. Accordingly, Y meets the ownership test of paragraph (e)(5) of this section and is a qualified personal service corporation.

Example (3). The facts are the same as in example (2), except that 40% of the stock of Y is owned by Z, a C corporation. The remaining 60% of the stock is owned directly by the employees of Y. Employees of Y own 90% of the stock, by value, of Z. Assume that Z independently qualifies as a personal service corporation. The result is the same as in example (2), i.e., 96% of the stock of Y is held, directly or indirectly, by employees of Y performing services in a qualifying field. Thus, Y is a qualified personal service corporation.

Example (4). The facts are the same as in example (3), except that Z does not independently qualify as a personal service corporation. Because Z is not a qualified personal service corporation, the Y stock owned by Z is not treated as being held indirectly by the Z shareholders. Consequently, only 60% of the stock of Y is held, directly or indirectly, by employees of Y. Thus, Y does not meet the ownership test of paragraph (e)(5) of this section, and is not a qualified personal service corporation.

Example (5). Assume that W, a C corporation, meets the function test of paragraph (e)(4) of this section. In addition, assume that all the employees of W are performing services for W in a qualifying field. Nominal legal title to 100% of the stock of W is held by employees of W. However, due solely to the operation of community property laws, 20% of the stock of W is held by spouses of such employees who themselves are not employees of W. In determining the ownership of the stock, community property laws are disregarded. Thus, Y meets the ownership test of paragraph (e)(5) of this section, and is a qualified personal service corporation.

Example (6). Assume that 90% of the stock of T, a C corporation, is directly owned by the employees of T. Spouses of T's employees directly own 5% of the stock of T. The spouses are not employees of T, and their ownership does not occur solely by operation of community property laws. In addition, 5% of the stock of T is held by trusts (other than a trust described in section 401(a) that is exempt from tax under section 501(a)), the sole beneficiaries of which are employees of T. The employees are not treated as owners of the trusts under subpart E, part I, subchapter J, chapter 1 of the Code. Since a person is not treated as owning the stock of a corporation owned by that person's spouse, or by any portion of a trust that is not treated as owned by such person under subpart E, only 90% of the stock of T is treated as held, directly or indirectly, by employees of T. Thus, T does not

meet the ownership test of paragraph (e)(5) of this section, and is not a qualified personal service corporation.

Example (7). Assume that Y, a C corporation, directly owns all the stock of three subsidiaries, F, G, and H. Y is a common parent of an affiliated group within the meaning of section 1504(a) consisting of Y, F, G, and H. Y is not engaged in the performance of services in a qualifying field. Instead, Y is a holding company whose activities consist of its ownership and investment in its operating subsidiaries. Substantially all the activities of F involve the performance of services in the field of engineering. In addition, a majority of (but not substantially all) the activities of G involve the performance of services in the field of engineering; the remainder of G's services involve the performance of services in a nonqualifying field. Moreover, a majority of (but not substantially all) the activities of H involve the performance of services in the field of engineering; the remainder of H's activities involve the performance of services in the field of architecture. Nevertheless, substantially all the activities of the group consisting of Y, F, G, and H, in the aggregate, involve the performance of services in the field of engineering. Accordingly, Y elects under paragraph (e)(5)(vi) of this section to be treated as one taxpayer for determining the ownership test of paragraph (e)(5) of this section. Assume that substantially all the stock of Y (by value) is held by employees of F, G, or H who perform services in connection with a qualifying field (engineering or architecture). Thus, for purposes of determining whether any member corporation is a qualified personal service corporation, the ownership test of paragraph (e)(5) of this section has been satisfied. Since F and H satisfy the function test of paragraph (e)(4) of this section, F and H are qualified personal service corporations. However, since Y and G each fail the function test of paragraph (e)(4) of this section, neither corporation is a qualified personal service corporation.

Example (8). The facts are the same as in example (7), except that less than substantially all the activities of the group consisting of Y, F, G, and H, in the aggregate, are performed in the field of engineering. Substantially all the activities of the group consisting of Y, F, G, and H, are, in the aggregate, performed in two fields, the fields of engineering and architecture. Y may not elect to have the affiliated group treated as one taxpayer for purposes of determining whether group members meet the ownership test of paragraph (e)(5) of this section. The election is available only if substantially all the activities of the group, in the aggregate, involve the performance of services in only one qualifying field. Moreover, none of the group members are qualified personal service corporations. Y fails the function test of paragraph (e)(4) of this section because less than substantially all the activities of Y are performed in a qualifying field. In addition, F, G, and H, fail the ownership test of paragraph (e)(5) of this section because substantially all their stock is owned by Y and not by their employees. The owners of Y are not deemed to indirectly own the stock owned by Y because Y is not a qualified personal service corporation.

Example (9). (i) The facts are the same as in example (8), except that Y itself satisfies the function test of paragraph (e)(4) of this section because substantially all the activities of Y involve the performance of services in the field of engineering. In addition, assume that all employees of Y are involved in the performance of services in the field of engineering, and that all such employees own 100% of Y's stock. Moreover, assume that one-third of all the employees of Y are separately employed by F. Similarly, another one-third of the employees of Y are separately employed by G and H, respectively. None of the employees of Y are employed by more than one of Y's subsidiaries. Also, no other persons except the employees of Y are employed by any of the subsidiaries.

(ii) Y is a personal service corporation under section 448 because Y satisfies both the function and the ownership test of paragraphs (e)(4) and (5) of this section. As in example (8), Y is unable to make the election to have the affiliated group treated as one taxpayer for purposes of determining whether group members meet the ownership test of paragraph (e)(5) of this section because less than

substantially all the activities, in the aggregate, of the group members are performed in one of the qualifying fields. However, because Y is a personal service corporation, the stock owned by Y is treated as indirectly owned, proportionately, by the owners of Y. Thus, the employees of F are collectively treated as owning one-third of the stock of F, G, and H. The employees of G and H are similarly treated as owning one-third of each subsidiary's stock.

(iii) F, G, and H each fail the ownership test of paragraph (e)(5) of this section because less than substantially all of each corporation's stock is owned by the employees of the respective corporation. Only one-third of each corporation's stock is owned by employees of that corporation. Thus, F, G, and H are not qualified personal service corporations.

Example (10). (i) Assume that Y, a C corporation, directly owns all the stock of three subsidiaries, F, G, and Z. Y is a common parent of an affiliated group within the meaning of section 1504(a) consisting of Y, F, and G. Z is a foreign corporation and is excluded from the affiliated group under section 1504. Assume that Y is a holding company whose activities consist of its ownership and investment in its operating subsidiaries. Substantially all the activities of F, G, and Z involve the performance of services in the field of engineering. Assume that employees of Z own one-third of the stock of Y and that none of these employees are also employees of Y, F, or G. In addition, assume that Y elects to be treated as one taxpayer for determining whether group members meet the ownership test of paragraph (e)(5) of this section. Thus, Y, F, and G are treated as one taxpayer for purposes of the ownership test.

(ii) None of the members of the group are qualified personal service corporations. Y, F, and G fail the ownership test of paragraph (e)(5) of this section because less than substantially all the stock of Y is owned by employees of either Y, F, or G. Moreover, Z fails the ownership test of paragraph (e)(5) of this section because substantially all its stock is owned by Y and not by its employees.

(6) Application of function and ownership tests. —A corporation that fails the function test of paragraph (e)(4) of this section for any taxable year, or that fails the ownership test of paragraph (e)(5) of this section at any time during any taxable year, shall change from the cash method effective for the year in which the corporation fails to meet the function test or the ownership test. For example, if a personal service corporation fails the function test for taxable year 1987, such corporation must change from the cash method effective for taxable year 1987. A corporation that fails the function or ownership test for a taxable year shall not be treated as a qualified personal service corporation for any part of that taxable year.

(f) Exception for entities with gross receipts of not more than \$5 million

(1) *In general.* —Except in the case of a tax shelter, this section shall not apply to any C corporation or partnership with a C corporation as a partner for any taxable year if, for all prior taxable years beginning after December 31, 1985, such corporation or partnership (or any predecessor thereof) meets the \$5,000,000 gross receipts test of paragraph (f)(2) of this section.

(2) The \$5,000,000 gross receipts test

(i) *In general.* —A corporation meets the \$5,000,000 gross receipts test of this paragraph (f)(2) for any prior taxable year if the average annual gross receipts of such corporation for the 3 taxable years (or, if shorter, the taxable years during which such corporation was in existence) ending with such prior taxable year does not exceed \$5,000,000. In the case of a C corporation exempt from federal income taxes under section 501(a), or a trust subject to tax under section 511(b) that is treated as a C

corporation under paragraph (a)(3) of this section, only gross receipts from the activities of such corporation or trust that constitute unrelated trades or businesses are taken into account in determining whether the \$5,000,000 gross receipts test is satisfied. A partnership with a C corporation as a partner meets the \$5,000,000 gross receipts test of this paragraph (f)(2) for any prior taxable year if the average annual gross receipts of such partnership for the 3 taxable years (or, if shorter, the taxable years during which such partnership was in existence) ending with such prior year does not exceed \$5,000,000. The gross receipts of the corporate partner are not taken into account in determining whether the partnership meets the \$5,000,000 gross receipts test.

(ii) *Aggregation of gross receipts.* —For purposes of determining whether the \$5,000,000 gross receipts test has been satisfied, all persons treated as a single employer under section 52(a) or (b), or section 414(m) or (o) (or who would be treated as a single employer under such sections if they had employees) shall be treated as one person. Gross receipts attributable to transactions between persons who are treated as a common employer under this paragraph shall not be taken into account in determining whether the \$5,000,000 gross receipts test is satisfied.

(iii) *Treatment of short taxable year.* —In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by (A) multiplying the gross receipts for the short period by 12 and (B) dividing the result by the number of months in the short period.

(iv) *Determination of gross receipts*

(A) *In general.* —The term “gross receipts” means gross receipts of the taxable year in which such receipts are properly recognized under the taxpayer's accounting method used in that taxable year (determined without regard to this section) for federal income tax purposes. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade or business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221(1), (3), (4) or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in 1221(2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (e.g., a repayment of the principal amount of a loan held by a commercial lender). Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts shall include the amounts received that are allocable to the payment of such tax.

(3) *Examples.* —The following examples illustrate the provisions of paragraph (f) of this section:

Example (1). X, a calendar year C corporation, was formed on January 1, 1986. Assume that in 1986 X has gross receipts of \$15 million. For taxable year 1987, this section applies to X because in 1986, the period during which X was in existence, X has average annual gross receipts of more than \$5 million.

Example (2). Y, a calendar year C corporation that is not a qualified personal service corporation, has gross receipts of \$10 million, \$9 million, and \$4 million for taxable years 1984, 1985, and 1986, respectively. In taxable year 1986, X has average annual gross receipts for the 3-taxable-year period

ending with 1986 of \$7.67 million (10 million + 9 million + 4 million/3). Thus, for taxable year 1987, this section applies and Y must change from the cash method for such year.

Example (3). Z, a C corporation which is not a qualified personal service corporation, has a 5% partnership interest in ZAB partnership, a calendar year cash method taxpayer. All other partners of ZAB partnership are individuals. Z corporation has average annual gross receipts of \$100,000 for the 3-taxable-year period ending with 1986, (*i.e.*, 1984, 1985 and 1986). The ZAB partnership has average annual gross receipts of \$6 million for the same 3-taxable-year period. Since ZAB fails to meet the \$5,000,000 gross receipts test for 1986, this section applies to ZAB for its taxable year beginning January 1, 1987. Accordingly, ZAB must change from the cash method for its 1987 taxable year. The gross receipts of Z corporation are not relevant in determining whether ZAB is subject to this section.

Example (4). The facts are the same as in example (3), except that during the 1987 taxable year of ZAB, the Z corporation transfers its partnership interest in ZAB to an individual. Under paragraph (a)(1) of this section, ZAB is treated as a partnership with a C corporation as a partner. Thus, this section requires ZAB to change from the cash method effective for its taxable year 1987. If ZAB later desires to change its method of accounting to the cash method for its taxable year beginning January 1, 1988 (or later), ZAB must comply with all requirements of law, including sections 446(b), 446(e), and 481, to effect the change.

Example (5). X, a C corporation that is not a qualified personal service corporation, was formed on January 1, 1986, in a transaction described in section 351. In the transaction, A, an individual, contributed all of the assets and liabilities of B, a trade or business, to X, in return for the receipt of all of the outstanding stock of X. Assume that in 1986 X had gross receipts of \$4 million. In 1984 and 1985, the gross receipts of B, the trade or business, were \$10 million and \$7 million, respectively. The gross receipts test is applied for the period during which X and its predecessor trade or business were in existence. X has average annual gross receipts for the 3-taxable-year period ending with 1986 of \$7 million (\$10 million + \$7 million + \$4 million/3). Thus, for taxable year 1987, this section applies and X must change from the cash method for such year.