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Re: Using Legal Documents & 'Pass-Through Business Entities' to drive Tax Results

Dear Clients, Colleagues, and Friends:

Potter v. *[IRS] Commissioner (2018)* is a recent Tax Court case illustrating three important tax and legal principles. First, its holding demonstrates why it is essential to use legal documents to help set-up a favorable tax result. Second, it is an example why to report business accountings on business tax returns and then flow the net to the individual vs. reporting the business activity at the individual level. Three, the case helps determine what is "labor" for tax purposes. Unfortunately Mr. Potter's legal and accounting did not support the return he signed.

Potter was an independent salesman for Green Country (GC), not its employee. His million dollar annual commissions were reported by his S corporation, Potter Sales, and then its net income flowed to his individual return. GC and Potter had a Termination Agreement (TA). If either party terminated the relationship, 1.5 times the prior year's commissions would be paid to Potter *individually*, which was different than the annual commissions being paid to his company.

In 2010 GC terminated Potter because they sold out to a competitor. Potter received $1.73 million pursuant to the TA. Directly on his individual return, and not Potter Sales, he reported a large capital gain from the sale of his Goodwill or his "book of business." The IRS contended Potter did not own a "book of business" to *exchange*[1] but rather the money was merely a severance payment subject to ordinary income tax rates, and therefore $400,000 more in tax is due. The Tax Court agreed by ruling that Potter did not own any goodwill.

The TA did not help Potter's case. The agreement apparently failed to use *exchange* language to help support a "book of business" was sold. For example it could have stated the parties recognize a valuable customer list is owned by Potter Sales and it is transferring the list to GC *in exchange* for $1.73 million. To effectuate Potter's intent the agreement would include an "assignment" conveying the customer list to GC, and Potter will assist with transition marketing, as well as convey to GC the "hard assets" used to generate the sales, and finally a covenant not to compete[2] against GC or its successor would be present.

[1] Tax law requires an 'exchange' of assets in order to qualify for capital gain, i.e. Potter swaps his contacts for cash.

[2] Potter did receive $200,000 for a covenant not to compete, which in my opinion, coupled with the $1.73 million does suggest he controlled a valuable customer list; accordingly he probably did own a "book of business."

It further may have been helpful to title the TA as an "Agreement for Sale of Goodwill" and avoid the term "termination." Termination is *indicia* of an ordinary income type payment for cessation of employment. Maybe the agreement could have stated the 1.5 times prior year's commission is a "book of business" arms-length valuing metric and the annual commissions are adequate consideration for prior work and no further money is owed for previous labors.

The IRS also prevailed that $50,000+ of self-employment tax is due. The Tax Court first noted Potter *individually* received the money. It concluded the payments were similar to retirement payments based on the quantity and quality of Potter's previous year's work; and said work was from his occupation as a salesman. The Court further noted the payments were not adjusted for any non-work[3] related factors. As such, the payments were directly connected to labor and therefore subject to SE tax. Potter would have avoided the SE tax issue if his S-corporation properly received the $1.73 million. S-corporations are not subject to SE tax. The same labor and S corporation issues that Potter litigated are going to be more prevalent starting this year because of the new tax law's 20% Business Income Deduction.

As per Footnote #2, Potter received $200,000 for a covenant not to compete. He reported it as a capital gain. But non-compete proceeds are ordinary income. Thus a facial error existed on the individual return that may have triggered the audit. A better approach would have been his business reports the large capital gain *and* the covenant's ordinary income and then pay tax on same through his personal return. That would have resulted in a simpler appearing Form 1040, and such reporting is consistent with most business transitions because typically in a sale of a business there is at least some ordinary income recognition. Potter had it 100% capital gain!

In addition, it is <u>not that common</u> for an individual return to report "Sale of Goodwill" for almost $2 million. That may have attracted the IRS's attention. The same gain on a 'final' corporate tax return is <u>not that unusual</u>. Thus, perhaps the audit could have been avoided with the business first reporting the gain; and the taxes would have been exactly the same. To legally document that Potter Sales reports the money first, just like he treated the annual commissions, Potter could have assigned his "rights, title, and interests" in the TA to his company.

In conclusion, Mr. Potter filed a return paying about the least he could and ended up paying the maximum. When a taxpayer suffers the worst possible outcome, lack of tax planning is probably the culprit. If Mr. Potter had used his legal documents to possibly set up a capital gain, and used tax accounting to better exploit his S-corporation, he might have yielded a better result. In our offices we work to achieve the better result. With the power of the dual view, we can analyze S-corporations and LLCs, draft business tax documents, prepare tax returns, design and implement accounting systems, and ultimately assist with your estate planning.

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[3] A non-work related factor might be GC's profits from the sales Potter generated.