CPA Firm Dissed by 7th Circuit Court of Appeals

Our tax lawyers have represented a fair number of clients in the Tax Court, and before the IRS in so-called unreasonable compensation tax audits. The issue generally arises in closely held C corporations who pay out all of their profits as salary to the shareholders, rather than allocating any portion to dividends. The advantage is that salaries are deductible--dividends are not. An IRS tax audit can, however, result in the IRS denying a portion of the salaries as not being an ordinary and necessary business expense pursuant to IRC Section 162.

That's what happened in Mulcahy, Pauritsch, Salvador & Co. v. Commissioner (7th Cir. 2012). Mulcahy et. al. is a medium size accounting firm in Illinois. According to its website the firm provides a variety of services including income tax preparation for all types of businesses and individuals, IRS and State tax audit representation, payroll reporting, QuickBooks setup support and training, business startup services, monthly bookkeeping and financial statements.

The Mulcahy firm appealed the IRS decision by filing a Petition with the United States Tax Court, and when it lost there they appealed to the 7th Circuit Court of Appeal hoping no doubt for a better result. After an analysis of the tax law, and the facts Judge Posner of the 7th Circuit decided against the CPA firm, and upheld the imposition of the 20% negligence penalty. Judge Posner rejected the defense to the penalty advanced by CPA firms tax attorneys that the CPA firm relied on the many individual employees of the firm who were "knowledgeable in income tax matters." He wrote "... there was conflict in this case: taking advice from oneself." But Judge Posner didn't stop there. First he badmouthed the firm's tax lawyers:
Remarkably, the firm's lawyers (an accounting firm's lawyers) appear not to understand the difference between compensation for services and compensation for capital, as when their reply brief states that the founding shareholders, because they "left funds in the taxpayer over the years to fund working capital," "deserved more in compensation to take that fact into account." True--but the "more" they "deserved" was not compensation "for personal services actually rendered." Contributing capital is not a personal service. Had the founding shareholders lent capital to the company, as it appears they did, they could charge interest and the interest would be deductible by the corporation. They charged no interest (emphasis in original).

Not content with leaving it there Judge Posner finished up as follows:
We note in closing our puzzlement that the firm chose to organize as a conventional business corporation in the first place. But that was in 1979 and there were fewer pass-through options then than there are now; a general partnership would have been the obvious alternative but it would not have conferred limited liability, which protects members' personal assets from a firm's creditors.

Why the firm continued as a C corporation and sought to avoid double taxation by overstating deductions for business expenses, when reorganizing as a passthrough entity would have achieved the same result without inviting a legal challenge [citation omitted] is a greater puzzle.
The Tax Court was correct to disallow the deduction of the "consulting fees" from the firm's taxable income and likewise correct to impose the 20 percent penalty. That an accounting firm should so screw up its taxes is the most remarkable feature of the case.

OUCH!

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