

Qualified Personal Service Corporation (PSC)

In a recent tax court case, Gurtman-Mazler Engineering, Inc., TC Memo 2008-140, the court ruled that the corporation was indeed a qualified Personal Service Corporation (PSC) and therefore subject to a flat federal tax rate of 35%, not the graduated income tax rate of other C corporations because it passed the ownership and function tests (*see below*). PSC status is only applicable to C corporations, not S corporations or LLCs.

The IRS and Congress typically take the stance that the decision to incorporate when made by personal service businesses is primarily for tax avoidance or to gain a tax advantage, such as the graduated corporate tax rate, the ability to deduct business expenses that would otherwise be subject to the limitations on miscellaneous itemized deductions, or the use of corporate retirement and fringe benefit plans. Therefore, Congress passed laws including the PSC rules to limit the benefits received by incorporated personal service businesses. Corporations that meet the various definitions of a PSC are subject to several special rules, mostly unfavorable to the corporation.

Qualifying as a PSC can be both good and bad—a PSC can generally use the cash method of accounting (good), but is not entitled to use the corporate graduated tax rates and is instead taxed at a flat 35% rate (bad). These rules affect PSCs in the fields of health (including veterinarians), law, **engineering (including surveying and mapping)**, architecture, accounting, actuarial science, performing arts, and consulting. PSCs are also prohibited from carrying back Federal net operating losses (must be carried forward) and are under some strict rules if they choose to use a non-calendar year-end.

Close-up: Tests that you hope to fail to avoid PSC status.

Regular C corporations pay tax based on graduated Federal tax rates that start at 15% and can climb as high as 39%. PSC's on the other hand are taxed at a flat rate of 35% so the typical tax planning strategy is to bonus out all of the income and pay little if no corporate tax. Of course the shareholders still pay rates up to the highest Federal income tax rates on the salaries they are paid, currently 35%.

The test to determine whether the corporation is a PSC subject to the flat 35% rate is the same test as the test to qualify for the cash method of accounting. If more than 95% of the time spent by employees is devoted to the performance of services in the qualifying fields then you qualify and pass the test, not the desired result especially for smaller corporations since regular C corporations with revenues under \$5 million already qualify to use the cash method.

Congress devised a special set of rules to thwart professional corporations from taking advantage of having a non-calendar year end that consists of three tests--the *compensation* test, the *ownership test* and the *function test*—to determine if those rules are being followed. These tests are tests that you want to fail

The *compensation* test states that if more than 20% of the total compensation costs attributable to personal services are performed by employee owners, you pass the test.

The *ownership test* states that at least 95% of the corporation's stock, by value, must be owned directly or indirectly by employees performing the services.

The *function test* states that the corporation is a PSC if “*substantially all*” of the corporation's activities involve the performance of services in the fields of health, law, **engineering**, architecture, accounting, actuarial science, performing arts, or consulting. This determination is

made based on compensation paid during the prior year if more than 50% of the compensation paid is attributable to activities that meet the test.

If you work in one of those fields and form a C corporation you are automatically a PSC for year-end purposes unless you have enough employees performing work so that as a shareholder you retain purely a management role. It's hard to get around the ownership rule by transferring stock to spouses since most states have limitations on who can hold the stock in licensed professional service corporations.

The definitions and rules in this area overlap several internal revenue code sections so determining the correct classification should be done with care and reviewed every year. The Gurtman-Mazler case shows that the IRS can make life unpleasant for the misclassified and that the IRS is still making it an audit issue. Seek the advice of an experienced CPA for proper advisement on these and all tax matters related to your business.

Even if you can't avoid PCS status, certain PSCs may still qualify to use a fiscal year other than a calendar year by establishing a business purpose for such a year, making the Section 444 election to use a fiscal year other than a calendar year, or making the election to use a 52-53-week tax year that ends with reference to the calendar year.

Since the PSC rules are quite complicated and generally result in a larger tax bill, most PSCs make an S election to avoid the complexity entirely which in most cases makes good tax sense.

Good News for Some Corporations

In the case of *Alron Engineering and Testing Corp v. Commissioner*, [80 T.C.M. (CCH) 603 2000], the Tax Court held that geotechnical services provided by the engineering corporation did not require the same education or training as engineering services did, and that geotechnical services were not dependent on the corporation's ability to provide engineering services. That being the case, none of the activities involved in geotechnical testing was able to be included in the "substantially all test" and, therefore, the taxpayer won and was able to take advantage of the graduated tax rates by not falling into the PSC classification.