

## Legal Risk Management Tip February 2017

### FLEISCHER V. COMMISSIONER – WHAT DOES IT MEAN FOR BUSINESSES?

On December 29, 2016, the United States Tax Court handed down a decision in the case of *Fleischer v. Commissioner of Internal Revenue*<sup>1</sup> which focused on the tax issue of whether Mr. Fleischer or his wholly-owned S-Corporation (“S-Corp”)<sup>2</sup> had to report the earned income that was at issue in the case. In addition to the tax issues, the decision provides additional guidance relating to some often misunderstood issues regarding entity formation, structure and operations that relate directly to small businesses, including a large number of financial industry advisers.

The purpose of this month’s legal tip is to highlight those corporate and business considerations that Jacko Law Group, PC (“JLG”) believes will bear directly on how business owners, including those serving as advisers and registered representatives of financial industry firms, go about managing and conducting their business affairs.

Please note that the below information does not constitute tax advice or tax counsel. In addition to qualified attorneys, business owners should work with professional advisers with expertise in tax and tax law issues.

#### **Summary of the Fleischer Case**

As described in *Fleischer*, Mr. Fleischer is a certified financial planner who holds a variety of securities and insurance licenses, including the Series 6, 7, 24, 63 and 65. On February 2, 2006, Mr. Fleischer, in his individual capacity, entered into an independent contractor representative agreement with LPL Financial Services (“LPL”). On February 7, 2006, Fleischer set up an S-Corp called Fleischer Wealth Plan (“FWP”) for which he was the sole owner and officer. On February 28, 2006, Fleischer entered into an employment agreement (“Employment Agreement”) with FWP, under which FWP paid him a salary in his capacity as a financial adviser.<sup>3</sup> The Court noted that the Employment Agreement did not include a provision that required Mr. Fleischer to remit any commission or fees from LPL (or any other third party) to FWP. On March 13, 2008, Mr. Fleischer, in his individual capacity, entered into a broker contract with MassMutual Financial Group (“Mass Mutual”) under which he was an independent contractor, and there was no mention of FWP in that broker contract.

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<sup>1</sup> See *Fleischer v. Commissioner of Internal Revenue*, T.C. Memo 2016-238, available here: <http://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=11057>.

<sup>2</sup> S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations are responsible for tax on certain built-in gains and passive income at the entity level. For more information, see 26 U.S. Code Section 1361 and the IRS website ([www.irs.gov](http://www.irs.gov)).

<sup>3</sup> The duties listed in the Employment Agreement included: (1) acting in the clients’ best interests in managing client investment portfolios; (2) expanding FWP’s client base and the overall presence of FWP; (3) drafting and reviewing financial documents; and (4) representing FWP diligently and responsibly at all times.

Both LPL and MassMutual reported payments made to Fleischer on Form 1099s issued to Fleischer, the individual. Fleischer, having transferred those payments to FWP, caused those payments to be reflected on the corporate tax returns filed by FWP, and filed his own personal returns indicating that he was not responsible for any self-employment taxes.

Upon review, the Internal Revenue Service (“IRS”) took the position that Mr. Fleischer was responsible for self-employment tax deficiencies based on the logic that the income from LPL and Mass Mutual was earned by him, and not FWP.

The Tax Court agreed with the IRS and held that Fleischer individually, and not FWP, should have reported the income under the LPL and Mass Mutual contracts. The Tax Court used a two prong test set forth in the case of *Johnson v. Commissioner*<sup>4</sup> to determine whether Mr. Fleischer or FWP was the proper party to recognize the income. Those criteria included: (i) whether the individual providing the services is an employee of the corporation who the corporation can direct and control in a meaningful sense,<sup>5</sup> and (ii) whether there exists between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation’s controlling position.

Based on Mr. Fleischer’s details and information and argument he presented, the Tax Court made the following findings, which factored directly into the rationale of its decision:

- FWP had no contractual relationship with LPL or MassMutual;<sup>6</sup>
- The revenue in question was attributable to contracts between third parties and Mr. Fleischer, not FWP;
- The Employment Agreement did not require Mr. Fleischer to remit revenues he received to FWP; and
- There was no indication that either LPL or MassMutual was aware that Mr. Fleischer was employed by FWP.

### **Lessons Learned**

Based on Fleischer, consider the following potential steps with respect to your business:

- When possible, enter into contracts in the name of your S-Corp, and consider revising those that were entered prior to its formation;
- Prepare a written employment agreement between you and your S-Corp;
- If you work in an industry, such as the financial services industry, where contracting in the name of an individual is required (whether by rule or as a function of practical

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<sup>4</sup> See *Johnson v. Commissioner*, 78 T.C. 882 (1982).

<sup>5</sup> The *Fleischer* Court did not expressly rule on this issue since it determined that Mr. Fleischer did not satisfy the other primary criteria of *Johnson*.

<sup>6</sup> Notably, Mr. Fleischer argued that the cost and expense to properly register an entity like FWP that is permitted to enter into a contract like those he entered with LPL and MassMutual was so great that it was practically impossible to do so. The Court rejected this argument noting that nothing in the relevant securities laws prohibited an entity like FWP from becoming properly registered to provide such services.

considerations), ensure that any contract between you and your S-Corp includes the relevant provisions cited in *Fleischer*;

- Work with trusted professional advisers who can help you navigate the complex statutes and regulatory rules applicable to your business.

## **Conclusion**

Each business' approach to the legal issues discussed above will be different, and depending upon the facts and circumstances applicable to a particular company, the structural considerations and contractual relationships will need to be customized to your organization. In addition, a business' tax adviser should be involved in any strategy that contemplates the holdings and guidance in *Fleischer* and related cases. It is critically important to proactively take steps now to consider and make adjustments to your operations that may be impacted by the legal decisions discussed in this Legal Tip so that you and your advisers can create a smart and comprehensive strategy designed to mitigate legal risks and maximize efficiency in your organization.

For more information on this topic, please contact us at (619) 298-2880 or at [info@jackolg.com](mailto:info@jackolg.com).

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