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BUSINESS E-BRIEF

COURT RECHARACTERIZES S CORPORATION DIVIDEND TO SHAREHOLDER-EMPLOYEE AS WAGES

A recent federal district court case (*Watson v. U.S.*, 107AFTR 2d 2011-311) has held that the IRS could recharacterize purported dividend payments to an S corporation shareholder-employee as wages. In this case, a CPA was a sole shareholder, employee, director and officer of a professional corporation that was taxed as an S Corporation. The corporation was a member of a firm that rendered accounting services. In the years at issue, the shareholder-employee paid himself a salary of $24,000.00 while he received dividend distributions totaling over $175,000.00 annually.

In this case, the taxpayer's wholly-owned S corporation was actually a 25% shareholder in an accounting firm with other members. All of the cash income to the taxpayer's professional corporation came exclusively from the accounting firm.

After reviewing all of the facts of the case, the court concluded that all of the distributions from the S corporation were in fact remuneration for services paid and recharacterized them as wages with all applicable employment taxes and penalties upon the failure to withhold those taxes being due.

This case illustrates the risk associated with structuring a business entity as an S corporation in an effort to minimize these employment taxes. If the taxpayer had structured this differently, he might have had a greater chance of success.

LOUISIANA SUPREME COURT REFUSES TO REVIEW NET OPERATING LOSS DECISION

The Louisiana Supreme Court has refused to review the decision of the First Circuit Court of Appeal in *ConAgra Foods, Inc. vs. Bridges*, 2010-0907 (La. App. 1st Cir. 10/29/10), 48 So.3d 1249. In ConAgra Foods, the First Circuit determined that ConAgra Foods, Inc. would receive the benefits of Louisiana net operating loss carryovers held by subsidiaries, which had been sold in Internal Revenue Code ("IRC") §338(h)(10) transactions . Under federal tax law, the parties to a stock sale can elect IRC §338(h)(10) treatment such that the stock sale is treated as an asset sale for income tax purposes and the tax attributes of the subsidiaries that are sold are acquired by the selling parent corporation. The steps that occur under an IRC §338(h)(10) transaction are as follows:

Step One: Prior to the transaction, a potential purchaser negotiates to acquire the stock of a subsidiary of a parent company.

Step Two: On the day of the transaction, the purchaser pays consideration for the stock of the subsidiary.

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Step Three: The assets of the subsidiary are treated as having been transferred to a new entity.

Step Four: The purchaser becomes the owner of the new entity.

Step Five: The old entity no longer has the assets that were moved to the new entity but does continue to have all of its tax attributes, including net operating losses.

Step Six: The old entity is liquidated into the parent company, which acquires the old entity's net operating losses. The liquidation is controlled by IRC §382, which allows net operating losses to transfer to the parent corporation.

In 1986, the Louisiana Legislature amended the Louisiana corporation income tax law so as to rely on the federal corporation income tax law, except for modification from federal tax law clearly provided for in Louisiana law. See La. R.S. 47:287.2 et seq.

In the ConAgra Foods case, the Department of Revenue did not dispute the federal tax treatment but contended that for Louisiana corporation income tax purposes, the net operating loss carryovers did not transfer to ConAgra Foods, the parent entity.

The court rejected the Department of Revenue's argument that the provisions of La. R.S. 47:287.86(I) precluded ConAgra Foods from being the corporation that acquired the net operating losses. The court held:

> *A close scrutiny of the two statutes [La. R.S. 47:287.86(I)(1) and IRC §381] reveals that the language utilized in La. R.S. 47:287.86(I)(1) is nearly identical to that employed under federal law. And the express provisions of La. R.S. 47:287.86(I)(1) indicate that the determination of "the acquiring corporation [that] shall succeed to and take into account, as of the close of the day of distribution or transfer, the aggregate net operating loss carryovers of the distributors or transferor corporation," is "subject to federal law and the limitations provided thereunder."*
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> *Because the Department has conceded that under federal law ConAgra as the parent selling corporation of the subsidiaries is entitled to succeed to and take into account the remaining tax attributes [including the net operating loss carryovers] after the deemed sale of the assets to Pilgrim's Pride and UAP [the purchasing entity] in the deemed liquidation of the subsidiaries back into the parent, and mindful of the nearly identical provisions of both Louisiana and the federal statutes, clearly ConAgra is the "acquiring corporation" of the NOLs for Louisiana state income tax purposes as well.*
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> *ConAgra Foods, 483 So.3d at 1252.*

The ConAgra Foods case will provide good authority for taxpayers who have relied on the incorporation of federal income tax law into the Louisiana corporation income tax system. Absent clear Louisiana statutes modifying the federal corporation income tax treatment for Louisiana corporation income tax purposes, taxpayers should be able to rely on the federal corporation income tax treatment.

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