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RETURN PREPARATION & BOOKKEEPING SERVICES ARE ACCOUNTING SERVICES FOR PSC

The Tax Court has held that a solely owned corporation that prepared tax returns and performed bookkeeping services was engaged in accounting for purposes of the qualified Personal Service Corporation (PSC) rules. As a result, the corporation was subject to the flat 35% tax rate.

Background. C corporations generally are subject to tax at graduated rates on their taxable income. The benefits of the graduated rates phase out after taxable income reaches a specified amount. By contrast, qualified personal service corporations (PSCs) are subject to special rules, including the rate that they are taxed at (a flat 35%) and the accounting method that they may use (cash). A corporation is a PSC if it meets the function and ownership tests:

1. Substantially all of its activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. “Substantially all” means that 95% or more of the time spent by the corporation's employees, serving in their capacity as employees, is devoted to performing such services. Brokerage services, including commission-based financial services, are excepted from consulting services.
2. Substantially all (95% or more) of the stock (by value) is held directly or indirectly by: employees performing the services or retired employees who had performed such services; or the estates of such employees, or any other person who, during the two-year period starting with the date that such an employee died, acquired that individual's stock because of his death. (Code Sec. 448(d)(2)).

Facts. Let’s take the case of Rainbow Tax Service, Inc., a solely owned Nevada corporation. It prepared federal and state individual, corporate, partnership, and transfer tax returns. It also performed bookkeeping services (profit and loss statements and various other reports relating to clients' federal payroll, state unemployment, and sales/use taxes). Rainbow wasn't a public accounting firm, none of its services required its employees to become certified public accountants (CPAs) and neither its principal nor its employees were CPAs. On its 2002 and 2003 returns, Rainbow computed its tax liability using regular corporate rates. IRS said Rainbow was a PSC and should used the flat 35% rate.

PSC function test met. Rainbow met the PSC ownership test. The key issue was whether it met the PSC function test as well. The Tax Court concluded that it did, pointing out that, historically, tax return preparation and bookkeeping services are regarded as within the field of accounting. It held that tax return preparation, which requires extracting information relating to financial transactions, analyzing that information, and then summarizing and reporting that information on a tax return, fits within the general definition of accounting. The Tax Court brushed aside Rainbow's argument that it wasn't in the business of accounting since Nevada required CPAs to perform accounting services. It pointed out that this argument failed to appreciate the difference between public accounting (which must be performed by CPAs) and accounting in general. It also noted that under Nevada law, public accounting includes the preparation of income tax returns.

As for Rainbow's bookkeeping services, the Tax Court said that “not only does bookkeeping constitute a “branch” of accounting, but our system of double-entry bookkeeping undergirds modern financial accounting." The Tax Court concluded that because Rainbow met the PSC function test and ownership test, it was subject to tax at the flat 35% rate for the years in question.