DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF CHIEF COUNSEL

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MEMORANDUM FOR KRISTI BECKWITH
REVENUE AGENT

FROM: Lynne Camillo
Chief, Employment Tax Branch 2
CC:TEGE:EOEG:ET2

SUBJECT: Income as Wages or Royalty Payments

This responds to your memorandum requesting advice on the proper tax treatment of payments received by an accountant who performs accounting services. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer
ABC PC
ABC LP
Year 1
Year 2
x
x1
x2
x3
x4
x5
x6
x7
x8
x9

ISSUE:

Whether amounts designated as royalty payments received by an accountant who performs accounting services should be properly classified as wages.

CONCLUSION:

The amounts designated as royalty payments are, in reality, payments for personal services rendered by the accountant. Remuneration for personal services performed by an employee is wages, subject to taxes under the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and income tax withholding.

FACTS

Taxpayer is a Certified Public Accountant engaged in the practice of accounting. Taxpayer is also President and % shareholder of ABC PC. ABC PC has been in existence for at least five years prior to Year 1. ABC PC claimed on its Form 1120 (U.S. Corporation Income Tax Return) in Year 2 that its business activity was professional services and that its product or service was accounting/management.

At the beginning of Year 1, Taxpayer entered into an employment contract with ABC PC. The employment agreement was to continue until terminated. Taxpayer signed the employment contract as the employee and also signed for ABC PC as the President. The contract contained an exclusive effort clause but not a covenant not to compete clause.

In August of Year 1, Taxpayer formed ABC LP, a limited partnership, along with four other people. Taxpayer was a limited partner with a % interest. Three of the other four limited partners were also corporate officers in ABC PC. The general partner was ABC Inc.[1] According to the ABC LP Agreement, the purpose of ABC LP was the transaction of any or all lawful business for which limited partnerships may be organized under state law. ABC LP claimed on its Form 1065 (U.S. Return of Partnership Income) in Year 2 that its principal business activity was investments, and the principal product or service listed was finance/rent.

[1]We assume that ABC PC and ABC Inc. are the same entity.

At the beginning of Year 1, Taxpayer purportedly entered into a license and royalty agreement with ABC LP.[2] In exchange for $x2 per year, the ABC LP was granted the exclusive right to the use of Taxpayer's client list.[3] ABC LP was given the exclusive right to render any professional accounting or business consulting services to clients on the list while the Taxpayer agreed to use his best efforts to direct his clients to ABC LP. The agreement was for two years with automatic renewals. ABC LP could increase the amount paid to Taxpayer. The agreement stated that the character of royalties was not to be construed as constituting compensation for services or earned income subject to FICA withholding. The agreement contained a covenant not to compete clause for 12 months after the termination of the agreement.

The following is a review of the flow of funds from the time clients paid ABC PC for accounting services and a description of how the wages, compensation for officers, and royalty payments were reported in Year 2. The fees from accounting clients passed to ABC PC. ABC PC paid compensation of $x to Taxpayer for his services as an officer.[4] ABC PC paid Taxpayer's wife wages of $x1 for her services as office manager. ABC PC paid accountants who were non-officer/shareholders of ABC PC wages slightly less than wages paid to Taxpayer, plus royalty payments of as much as $x3. These royalty payments were reported on Forms 1099-MISC. ABC PC paid ABC LP $x4 for what are described as royalty payments. ABC LP paid out royalty payments to the limited partners. In Year 2, Taxpayer received $x5 as royalty payments and reported the amount on his Form 1040 Schedule E. ABC LP took a depreciation deduction for the building ABC PC rented from ABC LP (ABC PC and ABC LP have the same address) and incurred losses on its business along with other losses from other partnerships.[5] These losses were then reported by Taxpayer and the other limited partners.

In Year 2, ABC PC paid out $x8 in officer compensation, $x6 in wages, and $x7 in royalty payments.

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[2]The copy of the agreement provided by the Taxpayer stated that it was made and was effective January 1 of Year 1. It was unsigned by the parties.

[3]It is unclear whether the client list was owned by ABC PC or by the Taxpayer.

[4]On the ABC PC Form 1120 for Year 2 that Taxpayer signed as both preparer and as President, he claimed to devote 90% of his time performing services for ABC PC.

[5]The Year 2 Form 1065 listed four different partnerships with losses totaling $x9 reported by ABC LP on line 4. Taxpayer signed the Form 1065 as the preparer and as President of ABC Inc., the General Partner of ABC LP.

LAW AND ANALYSIS

Sections 3101 and 3111 of the Internal Revenue Code ("the Code") impose on every employee and every employer, respectively, FICA tax on wages paid to the employee by his employer with respect to employment. Section 3102 requires every employer to withhold the employee's portion of the FICA tax.

Section 3121(a) of the Code provides that, for purposes of the FICA, the term "wages" means all remuneration for employment, with exceptions not relevant in this case. Section 3306(b) and 3401(a) of the Code contain similar definitions for purposes of the FUTA tax and income tax withholding, respectively. Under section 3121(b) the term "employment" means any service, of whatever nature, performed by an employee for the person employing him. Section 3306(c) of the Code contains a similar definition for FUTA tax purposes.

Section 3401(d) provides, in part, that for purposes of income tax withholding, the term "employer" means the person for whom the individual performs or performed any service, of whatever nature, as the employee of such person, except that if the person for whom the individual performs or performed the services does not have control of the payment of wages for such services, the term "employer" (except for purposes of the definition of wages) means the person having control of the payment of wages.

Section 3301 of the Code imposes on every employer a FUTA excise tax on the total wages paid by him during the calendar year with respect to employment.

The name by which the remuneration for employment is designated is immaterial. See Sections 31.3121(a)-1(c) and 31.3401(a)-1(a)(2) of the Employment Tax Regulations. Thus, salaries, fees, bonuses, and commissions on sales or on insurance premiums, are wages if paid as compensation for employment. Furthermore, the basis upon which the remuneration is paid is generally immaterial in determining whether the remuneration constitutes wages. Thus, it may be paid on the basis of piecework, or a percentage of profits; and it may be paid hourly, daily, weekly, monthly, or annually. See Sections 31.3121(a)-1(d) and 31.3401(a)-1(a)(3).

Revenue Ruling 68-499, 1968-2 C.B. 421, discussed whether royalties paid by a company to its employees for licenses to manufacture articles under patents owned by the employees were wages. The company paid royalties to five individuals for licenses to manufacture certain articles on which the individuals held the patents. Two of the individuals had no employment relationship with the company, while the other three were employed by the company. However, the licensing contracts were separate and distinct from the employment contracts. The royalties were not paid for services performed by any of the five individuals for the company. The royalties

were paid for licenses to manufacture certain articles, and not as remuneration for employment. The royalty payments were held not to be wages.

Revenue Ruling 68-498, 1968-2 C.B. 421, considered whether royalty payments received by an author were subject to taxes under the Self Employment Contributions Act. The author was also a teacher and was an employee within the meaning of the FICA. The author was held to be engaged in the trade or business of writing books and the royalty payments were includible in computing his net earnings from self-employment within the meaning of section 1402(a).

Royalty payments were discussed in *Commissioner v. Affiliated Enterprises*, 123 F.2d 665 (10th Cir. 1941), *cert. denied* 315 U.S. 812 (1942). In that case, the court reasoned that, "In general, 'royalty' is defined as a tax or duty or compensation paid to owners of a patent or copyright for the use of it or the right to act under it. 2 Bouv. Law Dict., Rawle's Third Revision, p. 2975; Webster's International Dictionary. While payment ordinarily is at a certain rate for each article or certain per cent of the gross sale, that in itself is not determinative. The purpose for which the payment is made and not the manner thereof is the determining factor. And while we ordinarily think of royalty as payment for patentable or copyrightable articles, it is not necessarily required that the creative idea be subject to patent or copyright."

Sierra Club Inc. v. Commissioner, 86 F.3d 1526, (9th Cir. 1996) involved the issue of whether the payments received by a tax-exempt organization from mailing list rentals and from an affinity credit card program were royalties.[6] The court noted that, although section 512(b)(2) of the Code excludes "royalties" from the definition of "unrelated business taxable income," the term "royalties" is not further defined by statute or by regulation. Therefore, the court indicated that it would "look to the 'ordinary, everyday senses' of the word." Citation omitted. The court then went on to quote Webster's Ninth New Collegiate Dictionary and Black's Law Dictionary. The court continued,:

> From the above, we can glean that "royalty" commonly refers to a payment made to the owner of property for permitting another to use the property. The payment is typically a percentage of profits or a specified sum per item sold; the property is typically either an intangible property right - such as a patent, trademark, or copyright -

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[6] The royalty issue has been litigated extensively in cases involving unrelated business taxable income (UBTI). A tax-exempt organization must pay taxes at normal corporate rates on UBTI. Royalties are excluded from UBTI. See Sections 511(a), 512(a)(1), and 512(b)(2) of the Code.

> or a right relating to the development of natural resources. Revenue Ruling 81-178, relied upon by the parties, supports defining royalty as a payment which relates to the use of a property right. It states that "payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes." [Citations omitted]. Thus, according to Revenue Ruling 81-178, by definition, royalties do not include payments for personal services. Rev. Rul. 81-178, 1981-2 C.B. 135. . . . we hold that under Section 512(b)(2) "royalties" are payments for the right to use intangible property. We further hold that a royalty is by definition "passive" and thus cannot include compensation for services rendered by the owner of the property.

In *Sierra Club Inc.*, the court concluded that payments relating to the rental of the mailing lists were royalties, as such payments were received for the right to use intangible property rights and did not include payments for services. However, there were disputed factual issues as to whether services were performed in connection with the credit card program. Accordingly, the case was remanded for a factual determination as to whether services were performed in connection with the credit card program. On remand, the Tax Court held that because no services were performed in connection with the credit card program receipts from such program were properly considered to be royalties. See *Sierra Club, Inc., v. Commissioner,* T.C. Memo. 1999-86.

For many years, courts have applied the economic substance doctrine, or a variant thereof, to disregard a diverse mix of transactions and entities that are devoid of economic substance other than the generation of tax benefits. The simple expedient of drawing up papers does not control for tax purposes when the objective economic realities are to the contrary. In *ACM Partnership v. Commissioner,* 157 F.3d 231 (3d Cir. 1998), *cert. denied* 119 S. Ct. 1251 (1999) the court stated, "[t]he inquiry into whether the taxpayer's transaction had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance' of the transactions (practical economic consequences, other than the creation of tax benefits) and the 'subjective business motivation' behind them (valid business purpose or profit motive). . . These distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes." (Citations omitted.) [7]

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[7] The economic substance doctrine has been applied in the context of an employment tax case. See *Fleck v. United States,* 2000-2 U.S.T.C. P50,665 (N.D. OH

Under the rationale applied by the court in *Sierra Club Inc.*, payments received by an accountant who performed accounting services are compensation for services. These payments do not constitute royalty payments but instead are wages. Taxpayer owns the accounting lists but the Taxpayer also performs accounting services for the accounting clients on the accounting lists. The payments received by the taxpayer were not for selling the accounting lists to another entity to perform accounting services but instead, were payments for the Taxpayer to perform accounting services. Whether the Taxpayer had sold the accounting lists to an entity controlled by the taxpayer or not, the Taxpayer was still going to perform the accounting services for those clients on the accounting lists. Royalty payments are by definition passive and thus cannot include compensation for services rendered by the owner of the property.

Taxpayer was performing accounting services for ABC PC under an employment contract. The ABC PC tax return listed him as spending 90% of his time performing services for ABC PC. Whether as an employee, shareholder and President of ABC PC, or as a limited partner to ABC LP he was performing accounting duties. The flow of funds from the accounting clients through ABC PC and ABC LP and finally to Taxpayer was generated by accounting services personally performed by Taxpayer as an employee of ABC PC. Applying the economic substance test, we are satisfied that there was no economic substance to the purported sale of accounting client lists and subsequent royalty payments to the Taxpayer. Given the significant amounts reported as royalty payments by the Taxpayer, both individually and by ABC PC and ABC LP, it is apparent that the classification of these amounts as royalty payments was merely a recharacterization of wages in order to avoid employment taxes.

The employment agreement characterized the payments as not being wages. The parties characterization of payments does not control the taxability of the payments. In *Phillies v. United States,* 153 F. Supp. 2d 612 (ED Dist. 2001) the court stated, "both FICA and FUTA define 'wages' as 'all remuneration for employment' unless excluded. 26 U.S.C. Sections 3121(a), 3306(b). 'Employment' as used in this definition means 'any service of whatever nature performed by an employee for the person employing him...' 26 U.S.C. Sections 3121(b), 3306(c)."[8]

2000).

[8]The term "service...means not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer." *Social Security Board v. Nierotko,* 327 U.S. 358, 365-66, 90 L.Ed. 718, 66 S. Ct. 637 (1946). Thus, in analyzing Taxpayer's relationship to ABC LP and ABC PC, we look at the entire record of the Taxpayer's activities involving ABC PC and ABC LP in the performance of accounting services.

Based on the expansive definition of wages, the definition of royalty payments, and the lack of economic substance of the parties' royalty arrangement, we conclude that amounts received by Taxpayer and other accountants performing services for ABC PC which were treated as royalty payments were, in fact, wages subject to FICA, FUTA, and income tax withholding.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Taxpayer provided the case of *Norwalk v. Commissioner*, T.C. Memo. 1998-279 for consideration. However, this case involved the distribution of an accounting corporation's intangible assets to its shareholders in a liquidation. It does not support Taxpayer's contention that the remuneration he received for performing accounting services should be treated as royalty payments.

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Please call if you have any further questions.

By: _____
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