Rainbow Tax Service, Inc. v. Commissioner, 128 T. C. 42 (U. S. Tax Court 2007)

The U. S. Tax Court ruled that Rainbow Tax Service, Inc. ‘s tax return preparation and bookkeeping services are classified as accounting services under IRC Sec. 448(d)(2), subjecting the company to a flat 35% corporate tax rate for qualified personal service corporations. This decision clarifies the broad scope of accounting services for tax purposes, impacting how tax preparation firms are taxed and potentially affecting their operational strategies to optimize tax liabilities.

Parties

Rainbow Tax Service, Inc. , as the petitioner, challenged the determination by the Commissioner of Internal Revenue, the respondent, regarding the classification of its services and the applicable tax rate.

Facts

Rainbow Tax Service, Inc. , incorporated in Nevada in 1978, provided tax return preparation and bookkeeping services. Initially owned by Steve Rodgers, the company expanded its operations and client base over the years. After Rodgers’ death in 2002, his wife, Donna Joyner-Rodgers, became president and assumed management of the company. The company’s stock was transferred to Rodgers’ estate and subsequently to Joyner-Rodgers in 2004. Rainbow Tax Service’s services included preparing various tax returns and bookkeeping, such as profit and loss statements and payroll tax reports, without requiring Certified Public Accountant (C. P. A.) licenses for its employees. For the tax years ending June 30, 2002, and 2003, Rainbow Tax Service calculated its tax liabilities using the graduated corporate income tax rates under IRC Sec. 11(b)(1).

Procedural History

The Commissioner issued a notice of deficiency on April 14, 2005, asserting that Rainbow Tax Service should be treated as a qualified personal service corporation under IRC Sec. 448(d)(2), subject to a flat 35% tax rate under IRC Sec. 11(b)(2). Rainbow Tax Service filed a timely petition with the U. S. Tax Court contesting this determination. The court reviewed the case de novo, focusing on whether the services provided by Rainbow Tax Service constituted accounting services for tax purposes.

Issue(s)

Whether Rainbow Tax Service, Inc. ‘s tax return preparation and bookkeeping services are to be treated as accounting services under IRC Sec. 448(d)(2), thus classifying the company as a qualified personal service corporation subject to the flat 35% tax rate under IRC Sec. 11(b)(2)?

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Rule(s) of Law

IRC Sec. 448(d)(2) defines a qualified personal service corporation as one whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and where at least 95% of the stock is owned by employees performing these services or their estates. IRC Sec. 11(b)(2) imposes a flat 35% tax rate on qualified personal service corporations. Temporary Income Tax Regs. Sec. 1. 448-1T(e)(4)(i) specifies that a corporation meets the function test if its employees spend 95% or more of their time performing the covered services, including incidental administrative and support services.

Holding

The U. S. Tax Court held that Rainbow Tax Service, Inc. ‘s tax return preparation and bookkeeping services constitute accounting services under IRC Sec. 448(d)(2). Consequently, Rainbow Tax Service was classified as a qualified personal service corporation subject to the flat 35% tax rate under IRC Sec. 11(b)(2) for the tax years in question.

Reasoning

The court reasoned that accounting encompasses a broader field than just public accounting, which requires C. P. A. licenses. The court cited Temporary Income Tax Regs. Sec. 1. 448-1T(e)(5)(vii), Example 1(i), which treats tax return preparation and the preparation of audit and financial statements as accounting services. The court rejected Rainbow Tax Service’s argument that only services requiring C. P. A. licenses should be considered accounting services, emphasizing that tax return preparation involves extracting, analyzing, and reporting financial transaction information, fitting within the general definition of accounting. Additionally, the court noted that bookkeeping is a recognized branch of accounting and is fundamental to modern financial accounting. The court concluded that substantially all of Rainbow Tax Service’s activities involved accounting services, satisfying the function test under IRC Sec. 448(d)(2)(A). The ownership test was also satisfied as Rodgers and his estate owned the stock during the relevant periods.

Disposition

The U. S. Tax Court entered a decision in favor of the Commissioner, affirming the classification of Rainbow Tax Service, Inc. as a qualified personal service corporation and the applicability of the flat 35% tax rate for the tax years in question.

Significance/Impact

This decision broadens the scope of what constitutes accounting services for tax purposes under IRC Sec. 448(d)(2), potentially affecting a wide range of tax

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preparation and bookkeeping firms. It establishes that such services, even if not performed by C. P. A. s, can qualify a corporation for treatment as a qualified personal service corporation, subject to a higher tax rate. This ruling may prompt tax service providers to reevaluate their business structures and tax strategies to mitigate the impact of the flat 35% tax rate. Subsequent cases have referenced this decision to clarify the classification of services in the context of qualified personal service corporations.

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