Liu v. Commissioner, T. C. Memo. 2020-31, United States Tax Court, 2020

In Liu v. Commissioner, the U. S. Tax Court ruled that income from an S corporation must be reported as ordinary income, not as qualified dividends. Mark Y. Liu and Ginger Y. Bian, deceased, had misreported their income from LB Education Corp. , leading to tax deficiencies. The court upheld the IRS's determination, emphasizing the legal classification of S corporation income. This decision clarifies the tax treatment of S corporation distributions, affecting how shareholders report such income on their returns.

Parties

Mark Y. Liu and Ginger Y. Bian, deceased, with Mark Y. Liu as surviving spouse, were the petitioners. The Commissioner of Internal Revenue was the respondent.

Facts

Mark Y. Liu and Ginger Y. Bian, who was deceased at the time of filing, each owned a 50% interest in LB Education Corp. , an S corporation operating Cypress Montessori School. For the tax years 2012 and 2013, LB Education Corp. reported ordinary income of $251,021 and $181,977, respectively, on its Forms 1120S. Liu and Bian filed joint Federal income tax returns for these years, reporting the income received from LB Education Corp. as qualified dividends on Forms 1099-DIV and Schedules K-1. The IRS examined their returns and determined that the income should be classified as ordinary income, leading to tax deficiencies of $29,156 and $26,751 for 2012 and 2013, respectively. Liu and Bian paid the total deficiency amount on June 23, 2018.

Procedural History

The IRS issued notices of deficiency on January 6, 2016, determining deficiencies and section 6663 penalties for the years in issue. Liu and Bian filed a petition with the U. S. Tax Court on April 13, 2016, which was treated as timely filed. The IRS conceded the section 6663 penalties during the proceedings. The Tax Court had jurisdiction under section 6213(a) to review the deficiencies. The IRS filed a notice of Federal tax lien (NFTL) on September 26, 2016, and later released it on December 7, 2018, and July 12, 2019, acknowledging the erroneous filing.

Issue(s)

Whether the income received by petitioners from LB Education Corp. should be classified and reported as ordinary income rather than qualified dividends for the tax years 2012 and 2013?

Rule(s) of Law

An S corporation's items of income, gain, loss, deduction, and credit flow through to its shareholders, who report their pro rata shares on their respective returns. The character of an S corporation item allocated to a shareholder is determined as if the item were realized directly by the shareholder. See I. R. C. § 1366(a), (b). Qualified dividend income includes dividends received from a domestic corporation and is taxed as net capital gain. See I. R. C. § 1(h)(11)(B)(i)(I).

Holding

The court held that the income received by petitioners from LB Education Corp. for the tax years 2012 and 2013 must be classified and reported as ordinary income rather than qualified dividends.

Reasoning

The court's reasoning focused on the statutory framework governing S corporations. The court noted that S corporations are not subject to Federal income tax at the entity level, and their income flows through to shareholders as ordinary income. The court referenced I. R. C. § 1363(a) and § 1366(a), (b), which dictate that the character of income from an S corporation is determined as if the shareholder realized it directly. The court found that the petitioners misreported the income as qualified dividends, which are subject to a different tax treatment under I. R. C. § 1(h)(11)(B)(i)(I). The court emphasized that the IRS's determination of ordinary income was correct based on the nature of the income reported by LB Education Corp. on its Forms 1120S. The court also addressed the petitioners' contention regarding interest on the deficiencies, clarifying that the Tax Court's jurisdiction does not extend to interest under I. R. C. § 6601 in deficiency proceedings.

Disposition

The court entered a decision for the respondent with respect to the deficiencies and for the petitioners with respect to the section 6663 penalties.

Significance/Impact

Liu v. Commissioner reinforces the principle that income from an S corporation must be reported as ordinary income by shareholders, clarifying the tax treatment of such distributions. This decision impacts how shareholders of S corporations classify and report their income, ensuring compliance with the Internal Revenue Code. It also highlights the Tax Court's limited jurisdiction over interest issues in deficiency proceedings, guiding future litigation strategies in similar cases. The case's treatment of the erroneous NFTL filing underscores the importance of accurate IRS administrative actions and their timely correction.