

[CORPORATE TAXPAYER],

Petitioner

v.

DECISION

MAINE REVENUE SERVICES,

Respondent

[Corporate Taxpayer] (the “Company”) appeals from a determination by Maine Revenue Services (“MRS”) disallowing certain business expense deductions that the Company claimed on its federal income tax returns for tax years [year 1] through [year 6]. The Company argues that MRS’s determination is incorrect and that the Company accurately filed its state and federal income tax returns for the period at issue. We disagree and uphold MRS’s determination in full.

I. Background

At all relevant times, the Company was a [non-Maine] corporation engaged in the business of selling [Products] in every state of the United States, including Maine. The Company was organized as an S corporation,¹ permitting undistributed income, earnings, profits, and losses to pass through to its shareholders without federal taxation at the corporate level. The Company’s two sole shareholders, [S-1] and [S-2], were both nonresidents of Maine.

[In the course of its business, in an effort to increase sales], the Company employed independent contractors to provide it with certain services, including the following:

1. solicitation of customers
2. product advertisement
3. dissemination of information

¹ An S corporation is a corporation that makes a valid election to be taxed under Subchapter S of Chapter 1 of the Internal Revenue Code, I.R.C. §§ 1361-1379.

4. assist customers in the use of purchased products
5. provide advertising advice to company salespersons
6. provide, at the Company's expense, a qualified and trained representative to give advice to customers regarding use of the products purchased

....

Sample Independent Contractor Agreement, [date].

During the period at issue, [S-1] and [S-2] were each 50% shareholders and the sole employees of a "Consulting Firm," another non-Maine corporation organized under I.R.C. Subchapter S. By contract dated [date] (the "Consulting Agreement"), the Company contracted with the Consulting Firm for certain services to increase its sales. Specifically, the Consulting Firm was required by the terms of the Consulting Agreement to "consult with and advise [the Company] regarding the following matters:

- i. providing [the Company] with its expertise and knowledge of the industry;
- ii. providing assistance in the marketing of concepts; [and]
- iii. providing [the Company] with its skills in the promotion of [the Company's] products through the use of media, publicity, and public relations."

Consulting Agreement § 1(a). In exchange for its services, the Company agreed to pay the Consulting Firm more than fifty percent of all gross income received by the Company.

Consulting Agreement § 3.² For the tax years at issue, the Company paid the Consulting Firm an average of \$[amount] per year in consulting fees, for which the Company took corresponding business expense deductions on its federal income tax returns. These deductions significantly reduced the apportionable income of the Company that flowed through to its two shareholders while increasing the income that they received as owners and employees of the Consulting Firm. Because the Consulting Firm claimed to be providing consulting services only in its [non-Maine] home state, the income that passed through to the Consulting Firm's shareholders and the income

² This percentage was subject to increase or decrease under certain conditions set forth in the Consulting Agreement. For the period at issue, the actual percentage ranged from 60% to almost 70% of the Company's gross income.

that was paid to them as employees of the Consulting Firm was not subjected to apportionment and taxation by any other state.

Prior to issuing the determination at issue in this case, MRS requested that the Company provide documentation or other evidence to substantiate the business expense deductions that it claimed for its payments to the Consulting Firm. Neither the Company nor either of its shareholders provided MRS with documents such as time sheets, work orders, invoices, or other records showing that the Consulting Firm had provided the Company with any services under the Consulting Agreement. MRS determined that there was insufficient evidence showing that the Company's payments to the Consulting Firm qualified for treatment as deductible business expenses under I.R.C. § 162(a) and disallowed the Company's deduction of those payments for income tax purposes for each year at issue, increasing the apportionable income flowing through the Company to its shareholders.³ The Company then filed this appeal challenging MRS's disallowance determination.

The Company contends that the Consulting Firm provided it with consulting services during the period at issue in accordance with the Consulting Agreement. Specifically, the Company argues that the Consulting Firm provided certain advertisement campaigns to the Company designed to increase profitability. Although individual members of the Consulting Firm, in their capacities as shareholders of the Company,⁴ may have approved the Company's use of such campaigns, no evidence was presented showing that the Consulting Firm was involved in the creation or production of any such campaigns.

³ Based on its determination disallowing the Company's business expense deductions, MRS also computed and issued assessments against the Company's shareholders for additional Maine income tax.

⁴ The Consulting Firm had no authority to act for or on behalf of the Company. Consulting Agreement ¶ 1(d).

The Company next-also argues that MRS is without authority to disallow its claimed expense deductions for the earlier tax years at issue, whereas those years are beyond the period of limitation under 36 M.R.S. § 141.

MRS also contends that the Company's payments to the Consulting Firm constituted sham transactions without economic substance, evoking the Company's duty to disprove MRS's averment.

The sole issue presented on appeal is whether the Company is entitled to its claimed business expense deductions for the payments that it made to the Consulting Firm in each of the years at issue. It is the Company's burden to show that, more likely than not, MRS's determination disallowing the business expense deductions is incorrect. 36 M.R.S. § 151-D(10)(F).

II. Discussion

Annually, a tax is imposed on the Maine net income of "each taxable corporation." 36 M.R.S. § 5200(1). For a corporate taxpayer, the term "Maine net income" is "the taxable income of that taxpayer for that taxable year under the laws of the United States as modified by section 5200-A and apportionable to this State under [36 M.R.S. §§ 5210-12]." 36 M.R.S.A. § 5102(8). "If a business, trade, profession or occupation is carried on partly within and partly without this State, the items of income and deduction derived from or connected with sources within this State shall be determined as apportioned to this State under [36 M.R.S. §§ 5210-12]" *Id.* § 5142(6). Because the Company had elected to be taxed for the years at issue in accordance with Subchapter S of the I.R.C., the Company's shareholders were subject to Maine income tax on

their proportionate shares of the Company's federal taxable income, as modified by 36 M.R.S. § 5200-A and apportioned to Maine under 36 M.R.S. §§ 5210-12.⁵

Federal taxable income upon which the Maine tax is based is defined as federal gross income minus certain deductions, including the deduction for trade or business expenses under I.R.C. § 162. *Id.* § 63. In turn, section 162(a)(1) provides a deduction for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . a reasonable allowance for salaries or other compensation for personal services actually rendered.” (Emphasis added). MRS has “the authority to interpret the applicable federal tax provisions” to ensure that the figures reported on a taxpayer's Maine returns comport with federal tax law. *Williams v. State Tax Assessor*, 2002 ME 172, ¶ 13 & n.4, 812 A.2d 245.

A. Deductible business expenses must be “ordinary”

A principal function of the term “ordinary” in I.R.C. § 162(a) is to distinguish those expenses that are currently deductible from those that are in the nature of capital expenditures. *Commissioner v. Tellier*, 383 U.S. 687 (1966), *Welch v. Helvering*, 290 U.S. 111 (1933). As applicable to the present case, however, the term “ordinary” also carries the more familiar connotation of “normal, usual, or customary.” *Deputy v. du Pont*, 308 U.S. 488, 495 (1940), *see also INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 85-86 (1992) (“to qualify as ‘ordinary,’ the expense must relate to a transaction ‘of common or frequent occurrence in the type of business involved’”) (quoting *Deputy v. du Pont* at 495).

⁵ The Maine adjusted gross income of a nonresident individual is that part of the individual's federal adjusted gross income that is derived from Maine sources, including

[t]he net amount of items of income, gain, loss, and deduction entering into the nonresident individual's federal adjusted gross income that are derived from or connected with sources in this State, including . . . *the individual's pro rata share of the income of an S corporation derived from or connected with sources in this State.*

36 M.R.S. §§ 36 M.R.S § 5102(1-C)(B), 5142(1)(A)(iii) (emphasis added).

In *Deputy v. du Pont*, an individual stockholder made certain expenditures to acquire stock for other key employees of the E.I. du Pont de Nemours Company and attempted to deduct the expenditures on his individual income tax return as ordinary and necessary business expenses. In finding that the expenditures were not deductible by the individual stockholder, the United States Supreme Court stated that “these payments were not ‘ordinary’ ones for the conduct of the kind of business in which, we assume arguendo, [the stockholder] was engaged. . . . The record does not show that [the stockholder] was in the business of trading in securities.” *Id.* at 494-96.

In the present case, no evidence was submitted showing that any other companies or individuals engaged in the business of selling [Products] would normally employ consultants to help increase sales and profitability, and to minimize customer attrition. However, we do not think that such services are so unusual as to constitute grounds for disallowing the payments for such services as not “ordinary” under I.R.C. § 162(a). *See Deputy v. du Pont*, 308 U.S. at 496 (“Review of the many decided cases is of little aid since each turns on its special facts. But the principle is clear.”). We decline to uphold MRS’s disallowance of the expense deduction on this basis. Accordingly, we examine the remaining components of the deduction.

B. Deductible business expenses must be “necessary”

The term “necessary” as used in I.R.C. § 162(a) “imposes only the minimal requirement that the expense be ‘appropriate and helpful’ for the development of the [taxpayer's] business.” *INDOPCO, Inc. v. Commissioner*, 503 U.S. at 85 (quoting *Commissioner v. Tellier*, 383 U.S. at 689; *Welch v. Helvering*, 290 U.S. at 113) (quotation marks omitted). Certainly, any consulting services that helped to increase sales, increased profitability, and minimized attrition would be most “appropriate and helpful” to a company. Viewed abstractly, we agree that the consulting

services contemplated under the Consulting Agreement are “necessary” to the Company’s business.

C. Deductible personal services must be “actually rendered”

For personal services, such as the consulting services at issue in this case, to be deductible as a business expense under I.R.C. § 162(a), the “taxpayer must demonstrate that the . . . services were actually rendered.” *Elick v. Comm’r*, T.C. Memo 2013-139 at 8-9, 105 T.C.M. (CCH) 1822.

In *Elick*, the taxpayer was a corporation doing business as a dental practice. Dr. and Mrs. Elick were salaried employees of the taxpayer, and were its sole shareholders and sole board members. Dr. Elick established a second company (the “Management Company”) to manage the taxpayer's operations. Under the management agreement, the Management Company was obligated to (1) produce annual capital, operating, and cashflow budget plans; (2) investigate and document in writing customer complaints; (3) develop policies and procedures; (4) recruit, supervise and train petitioner's employees; (5) perform fiscal services; and (6) ensure regulatory compliance. In exchange for these services, the taxpayer agreed to pay management fees of 1% to 25% of the taxpayer’s monthly gross receipts. The Management Company had no paid employees, but Dr. Elick entered into a written agreement to be a “co-employee” of both the taxpayer and the Management Company. Although the Management Company never issued any invoices to the taxpayer, the taxpayer paid management fees of \$430,000 for the first year and \$303,000 for the second, which equaled 9.76% and 9.98%, respectively, of petitioner's annual gross receipts for the two years at issue.

In disallowing the taxpayer’s claim of business expense deduction for fees that it paid to the Management Company, the Internal Revenue Service (“IRS”) reasoned that the fees were not

necessary business expenses for purposes of the deduction under I.R.C. § 162(a) because no management services were ever rendered. The taxpayer did not provide any documentation showing that the Management Company performed any services for it, and did not provide contemporaneous records showing that it received any services from the Management Company. Although the taxpayer contended that the services provided were those listed in the management agreement, the Tax Court recognized that the management agreement was only an indication of the services that the Management Company agreed to perform; it did not demonstrate that the Management Company in fact performed any services benefiting the taxpayer. Although the taxpayer did receive some services, the evidence provided showed that those services were performed by the taxpayer's employees or by third parties, and not by the Management Company. The Tax Court held that the taxpayer failed to show that the Management Company provided any of the services that it was obligated to provide under the management agreement, and that the deduction of management fees was properly disallowed on the ground that the taxpayer did not demonstrate that the fees were therefore necessary.

In the present case, neither the Company nor any shareholder submitted any time sheets, work orders, invoices, or other documentation supporting the Company's claim that the Consulting Firm provided it with services deductible as business expenses under I.R.C. § 162(a). According to the evidence presented, the Consulting Firm's employees did not "track their hours on a micro basis and [did] not have formal job descriptions, as they [were] the owners and sole employees of [the Consulting Firm]." Company correspondence to MRS dated [date]. The Company has not shown that the Consulting Firm actually provided services to it as required by I.R.C. § 162(a) so as to entitle the Company to its claimed business expense deductions. Adopting the reasoning of the Tax Court in *Elick*, we find that the Company has not shown that

the payments that it made to the Consulting Firm were “necessary” to the Company within the meaning of I.R.C. § 162(a). Because the Company has not met its burden of showing that MRS’s disallowance of its business expense deductions were in error, we hereby uphold MRS’s determination disallowing the Company’s expense deductions for payments made to the Consulting Firm, and we further uphold MRS’s subsequent recomputation of the Company’s shareholders’ Maine income tax liability for the period at issue.

D. Deductible personal services must be reasonable in amount

Even if certain expenditures are ordinary and necessary, they must also be reasonable in amount to be deductible under I.R.C. § 162. “Clearly it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount.” *Commissioner v. Lincoln Electric Co.*, 176 F.2d 815, 817 (6th Cir. 1949). “An expenditure may be, by its nature, ordinary and necessary, but at the same time it may be unreasonable in amount. In such a case[,] only the portion which was reasonable would qualify for a deduction under § 162(a).” *United States v. Haskel Eng’g & Supply Co.*, 380 F.2d 786, 788-789 (9th Cir. 1967).

Because the evidence in the present case is insufficient to show whether the Consulting Firm performed any of the services required under the Consulting Agreement, any determination regarding the reasonableness of the fees that the Company deducted as business expenses on its returns would be speculative at best. Thus, we do not reach this issue.

E. Statute of Limitation

MRS disallowed the Company’s expense deduction regarding its payments to the Consulting Firm during [year 1] through [year 6]. The Company argues that MRS is without authority to disallow or recompute the information contained on the returns that it filed for at

least three of those years due to their being outside the three-year statute of limitation provided under 36 M.R.S. § 141.⁶

Under section 141(1), MRS may determine the correct tax liability and may make any necessary assessments “within 3 years from the date the return was filed or 3 years from the date the return was required to be filed, whichever is later.” Ordinarily, Maine’s three-year statute of limitations applies except where the liability shown on a filed return is less than 1/2 of the correct tax liability. 36 M.R.S. § 141(2)(A). In such case, “[a]n assessment may be made within 6 years from the date the return was filed . . . after adjustments necessary to correct any mathematical errors apparent on the face of the return” *Id.* In determining the 50% threshold, MRS “may not consider any portion of the understated tax liability for which the taxpayer has substantial authority supporting its position.” *Id.*

In the present case, the Company argues that the 6-year statute of limitation does not apply because it had been audited by the IRS prior to the years at issue and the IRS did not disallow or otherwise adjust the Company’s claimed business expense deductions. The Company also contends that it “was reasonable for [it] to believe that the deduction taken for payments made to [the Consulting Firm] were valid deductions.” Company correspondence to the Maine Board of Tax Appeals dated [date].

The term “substantial authority” is not defined in Maine statutes. However, federal tax law succinctly provides that “[t]here is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.” *John Swenson Granite, Inc. v. Assessor*, 685 A. 2d 425, 429 n.3 (Me. 1996) (quoting Treas. Reg. § 1.6662-4(d)(3) (1996)). In this case, neither the

⁶ The Company does not contend that any of the tax years is outside the six-year limitation that we find applicable in this case.

claimed tacit acceptance of the Company's business expense deductions by the IRS nor the claimed reasonable belief of the Company that its deductions were correct constitutes authority for limiting the assessment period to three years under 36 M.R.S. § 141(2)(A). No adjustment to MRS's determination is warranted on this basis.

F. Sham Transaction - Lack of Economic Substance

Because we find that the Company has not met its burden to show that MRS's disallowance of its deduction from income of the payments that it made to the Consulting Firm was incorrect, we do not reach the issue of whether the Company's payment to the Consulting Firm was a sham transaction, rather than one where "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." *Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015) (quoting *Frank Lyon Co. v. United States*, 435 U.S. 561,583-84 (1978)).

III. Decision

Based on the evidence presented, we uphold in full the MRS's determination disallowing the Company's claimed business expense deductions for [year 1] through [year 6].

The Board may, in limited circumstances, reconsider its decision on any appeal. If either party wishes to request reconsideration, that party must file a written request with the Board within 20 days of receiving this decision. Contact the Appeals Office at 207-287-2864 or see the Board's rules, available at <http://www.maine.gov/boardoftaxappeals/lawsrules/>, for more information on when the Board may grant reconsideration. If no motion for reconsideration is filed within 20 days of the date of this proposed decision, it will become the Board's final administrative action. If either party wishes to appeal the Board's decision in this matter to the

Maine Superior Court, that party must do so within 60 days of receiving this decision. During the 60-day period in which an appeal may be filed with the Superior Court, the Company may contact Maine Revenue Services at 207-624-9725 for the amount of tax that is currently due, together with any interest or penalties owed. After that 60-day period has expired, Maine Revenue Services will contact the Company with an updated amount of tax and any interest or penalties due at that time.

Issued by the Board: April 5, 2017