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12 of 18 DOCUMENTS

**NAME:** IN RE: \* \* \*

**NUMBER:** HEARING NO. 41,355

**COURT:** COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS

**CITE:** 2002 *Tex. Tax LEXIS 205*

**DATE:** September 6, 2002

**PANEL:** [\*1]

JOE GRECO, Administrative Law Judge

**COUNSEL:** ELIAS V. LORENZANA, JR., Representing Administrative Hearings Section

\* \* \*, Representing Petitioner

**OPINIONBY:** GRECO

TAXPAYER NO.: \* \* \*

AUDIT OFFICE: \* \* \*

REPORT PERIOD: 1997 THROUGH 1999

FRANCHISE TAX/RDT

**COMPTROLLER'S DECISION**

**PRELIMINARY DISCUSSION:**

At the request of the Petitioner, this case is being decided based upon the written submissions of the parties.

Unless otherwise indicated, Section references are to Title 2 of the Texas Tax Code, and Rule references are to sections of Title 34, Texas Administrative Code. Notice has been taken of Comptroller's records pertinent to Petitioner or the issues raised in this case.

**PETITIONER'S CONTENTIONS:**

1. Compensation paid to officers/directors is excludable from earned surplus under Rule 3.358(g)(3).
2. The liability should be compromised or settled under Section 111.102, because Petitioner is insolvent.

**FINDINGS OF FACT:**

1. During the audit period, Petitioner was in the business of providing medical services.
2. Petitioner was audited for franchise tax compliance for the 1997 - 1999 report years. As a result, on July 10, 2001, the Comptroller issued a Texas Notification of Audit Results [\*2] to Petitioner assessing an amount of tax, penalty, and interest.
3. For each report year within the audit period, the auditor adjusted Petitioner's (reported) earned surplus by including compensation paid to officers/directors.

4. Petitioner's officers/directors are physicians. Their compensation was processed through normal payroll (i.e., via the issuance of Federal Form W-2).

5. As support for its second contention Petitioner submitted copies of its Federal tax returns for the years 1996 through 1998, and an unaudited, consolidated balance sheet for years 1999 through 2001. Petitioner's Federal tax returns show losses, and the unaudited balance sheets show deficits.

6. Petitioner ceased doing business on April 5, 2001. n1

n1 Source: Comptroller's records.

7. Petitioner's Certificate of Dissolution, issued by the Texas Secretary of State, was effective April 5, 2001.

#### **DISCUSSION AND CONCLUSIONS OF LAW:**

Regarding Petitioner's first contention, Section 171.110 provides as follows:

(a) The net taxable earned surplus of a corporation is computed by:

(1) determining the corporation's reportable federal taxable income, subtracting from that amount any amount included in [\*3] reportable federal taxable income under Section 78 or Sections 951-964, Internal Revenue Code, and dividends received from a subsidiary, associate, or affiliated corporation that does not transact a substantial portion of its business or regularly maintain a substantial portion of its assets in the United States, and **adding to that amount any compensation of officers or directors**, or if a bank, any compensation of directors and executive officers, to the extent excluded in determining federal taxable income to determine the corporation's taxable earned surplus; (Emphasis added.)

\* \* \* \*

(i) For purposes of this section, any person designated as an officer is presumed to be an officer if that person:

(1) holds an office created by the board of directors or under the corporate charter or bylaws; and

(2) has legal authority to bind the corporation with third parties by executing contracts or other legal documents.

(j) A corporation may rebut the presumption described in Subsection (i) that a person is an officer if it conclusively shows, through the person's job description or other documentation, that the person does not participate or have authority to participate [\*4] in significant policy making aspects of the corporate operations.

\* \* \* \*

Additionally, Rule 3.58 relating to earned surplus, officer and director compensation, provides, in part as follows:

(b) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

\* \* \* \*

(3) Compensation--The amount reportable to an officer or director for the tax reporting period as includable in the officer/director's federal taxable income without regard to any monetary limitations imposed for federal income tax purposes. Compensation does not include any amount reported to an officer/director which is disallowed as a reduction to federal taxable income for any taxable period for federal income tax purposes. For example, compensation does not include employee remuneration for which a deduction is disallowed under Internal Revenue Code, § 162(m). Compensation is included wherever reportable on federal tax reporting forms

including a Form W-2 Wage and Tax Statement, a Form 1099-MISC, or Schedule K-1 of Form 1065. For example (if all compensation is deductible):

(A) if a corporation (subject to the add-back [\*5] of officer and director compensation) issues a Form W-2 to an officer, the compensation included in earned surplus is the amount reflected on Form W-2 that must be included in the officer's federal taxable income (Block 10 of the 1991 Form W-2);

(B) if a corporation (subject to the add-back of officer and director compensation) issues an officer and director of a corporation a Form W-2 and a Form 1099-MISC, compensation included in the corporation's earned surplus for that officer/director is the sum of the amount reflected on Form W-2 that the officer must include in federal taxable income, the amount reflected on Form 1099-MISC as nonemployee compensation that the director must include in federal taxable income, plus any compensation which would be reportable on Form 1099-MISC except for monetary limitations.

\* \* \* \*

(d) If an individual is an officer or director of a corporation, all compensation to such individual in any capacity as an employee (as defined in subsection (b)(2) of this section) of such entity is included in computing earned surplus.

\* \* \* \*

(g) Exemptions from compensation add-back.

(1) Compensation is not included in computing earned surplus under the [\*6] Tax Code, § 171.110, to the extent the compensation is attributable to any portion of a tax reporting period when a corporation has fewer than 36 shareholders, a limited liability company has fewer than 36 members, or a limited banking association has fewer than 36 participants and participant-transferees.

(2) A corporation or other entity subject to franchise tax is not required to include compensation in computing earned surplus for any portion of a tax reporting period during which the entity qualifies for treatment as an S corporation for federal income tax purposes. If the corporation fails to qualify as an S corporation or S corporation status is terminated for any reason, the compensation will be included in determining earned surplus at the earlier of the time that the entity fails to qualify as an S corporation or S corporation status is terminated unless the entity otherwise qualifies to exclude compensation in computing earned surplus.

(3) For the purposes of this subsection, remuneration of officers and directors shall not be considered compensation if such remuneration is excessive. Factors used in determining to what extent remuneration is excessive may include, but [\*7] are not limited to:

(A) the officer's or director's qualifications;

(B) the nature, extent, and scope of the officer/director's work;

(C) the size and complexity of the business;

(D) a comparison of remuneration with the gross and net income of the business;

(E) the prevailing general economic conditions;

(F) remuneration compared to distributions to shareholders;

(G) prevailing rates of remuneration for comparable positions in comparable concerns;  
and

(H) the remuneration policy of the taxpayer as to all employees.

\* \* \* \*

Petitioner argues that the auditor should not have adjusted its reported earned surplus to include compensation paid to its officers/directors, because such compensation was "excessive," and (therefore) excludable under Rule 3.558(g)(3). As support, Petitioner asserts that its officers/directors "were only involved in periodic conference calls and the signing of required corporate documents to maintain the corporation." Petitioner asserts that the compensation paid to officers/directors was actually payments of earn-outs representing adjustments to the purchase price paid for non-medical assets of the officers'/directors' medical practices. [\*8] n2

n2 No evidence was submitted in support of this assertion.

The Administrative Hearings Section (AHS) argues that the compensation at issue was processed through normal payroll (Federal Form W-2); therefore, the ". . . compensation cannot be deleted from the earned surplus component," citing Rule 3.558(b)(3)(A)-(B). Further, the AHS argues that Petitioner has failed to submit evidence that the officer/director compensation at issue falls squarely within the terms of Rule 3.558(g)(3), relating to excessive compensation.

Petitioner has not shown that it is entitled to relief under Rule 3.558(g)(3). More importantly, Section 171.110 directs that any compensation paid to officers and directors of corporations (not otherwise excluded by statute) be included in earned surplus for franchise tax purposes. Further, the amount of officer/director compensation includable in earned surplus is the amount shown on the Federal Form W-2, as in the instant case. Rule 3.558(b)(3). Finally, consistent with the Section 171.110 requirement, Rule 3.558(d), provides that "if an individual is an officer or director of a corporation, all compensation to such individual in any capacity as an employee [\*9] . . . of such entity is included in computing earned surplus." Accordingly, based on the foregoing, it appears that the compensation paid to Petitioner's officers/directors was properly included in audited earned surplus.

Regarding Petitioner's second contention, Section 111.102 provides the Comptroller with the authority to compromise or settle a liability, if the taxpayer is insolvent (or the collection of the amount of tax due at one time would make the taxpayer insolvent), in liquidation, or has ceased to do business, and the taxpayer either does not have property that can be seized by the courts or the value of the taxpayer's property is less than a combination of the tax due and the amount of debts against the property.

Section 111.102 calls for an initial determination of whether the taxpayer financially qualifies for relief. If the taxpayer files the required financial information, and that information shows that the taxpayer qualifies financially for relief under the statute, then the next step is a determination by the Comptroller as to whether to exercise the authority to compromise or settle the liability.

As support for its second contention, Petitioner asserts that it [\*10] has dissolved, and has no remaining assets to satisfy the tax liability. Petitioner also points out that its sole shareholder, \* \* \*, whose assets were liquidated to repay the indebtedness to secured creditors, is also insolvent.

The AHS opposes Petitioner's second contention, arguing that Petitioner did not provide sufficient documentation for its insolvency claim, asserting, among other things, that Petitioner did not provide Federal tax returns for the years 1999 through 2001, "did not provide income statements for the periods under audit," and did not provide a property inventory and information relating to its distribution. The AHS also opposes relief, since Petitioner is no longer in business.

There is precedent to support the AHS' argument that a liability should not be settled under Section 111.102, where an entity is no longer in business. In that regard, Decision No. 30,273 (1994) states, in relevant part, as follows:

. . . However, the Tax Division opposes Petitioner's request for relief, and (as support) argues that since Petitioner is no longer in business ". . . the State would derive no benefit from settling the audit liability . . ." Apparently, the Tax Division's [\*11] position is that the purpose of Section 111.102 is to provide a means of settling the liabilities (in whole or in part) of going concerns that are in the midst of "hard times." Seemingly, the Tax Division believes that, on balance, there is little or no benefit to be gained by the State in settling or dismissing a liability of a business that essentially exists in name only. There is precedent for the Tax Division's position. For example, in Comptroller's Decision No. 28,751 (1992), the Comptroller sustained the same basic argument that has been advanced by the Tax Division in this hearing, and (in doing so) stated, at p. 3, as follows:

I tend to agree with the Tax Division that the purpose of the statute is to allow businesses to continue to function without a crushing tax burden (and therefore continue to operate and generate tax revenues for the State of Texas). That incentive, of course, does not exist in this case because Petitioner has ceased business operations.

**NOTE:** The Comptroller also recognizes the potential for the State to derive other direct and indirect benefits with respect to "going concerns" in similar situations such as the continued employment of workers, [\*12] payment of accounts payable, and both the production and purchase of goods and services.

For the same result, *see* Decision Nos. 38,779 (2000) and 28,510 (1994).

Given the above precedent, even if Petitioner had fully documented its request for insolvency relief, relief would not have been granted, since the facts show that Petitioner is no longer in business, and that its corporate charter has been dissolved.

**RECOMMENDATION:**

Petitioner's contentions should be denied. The audit liability should be upheld as originally issued.

SIGNED September 6, 2002.

**ORDER OF THE COMPTROLLER**

The above decision of the Administrative Law Judge, resulting in Taxpayer's liability as set out in Attachment "A" which is incorporated by reference, is approved and adopted in all respects. This decision becomes final twenty-three (23) days from the date of this Order, and the total sum of the tax, penalty, and interest amounts is due and payable within twenty (20) days thereafter. If such sum is not paid within such time, an additional penalty of ten percent of the taxes due will accrue, and interest will continue to accrue.

If a rehearing is desired, a Motion for Rehearing must be filed [\*13] with the Administrative Law Judge no later than twenty-three (23) days after the date of this Order, and must state the grounds upon which the motion is based.

RENDERED and ISSUED September 6, 2002.

CAROLE KEETON RYLANDER, Comptroller of Public Accounts of the State of Texas

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