LEGAL UPDATE

CLIENT NEWSLETTER OF

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INTERNATIONAL TAX NO PLANNING COSTS PLENTY

On June 17, 2010 the U.S. Court of Appeals for the First Circuit decided an international tax case which vividly illustrates the high cost of not planning. In *Estate of Charania v. Shulman*, 2010 U.S. App. LEXIS 12415, the U.S. Tax Court was presented with the following simple fact situation. Decedent, a resident of Belgium, died in 2002. He was born in 1930 in Uganda and was a citizen of the United Kingdom (UK). In 1962 Uganda became independent from Britain. He married his UK-citizen wife in 1967 in Uganda and at no time before or after the marriage entered into a marriage contract. While living in Uganda decedent was the agent of a Belgian shipping company.

In 1972, Idi Amin, the President of Uganda, ordered the expulsion of Ugandans of Asian descent. Accordingly, decedent and his family left Uganda permanently and moved to Belgium, where he continued to work as agent for the shipping company. Both decedent and his wife remained citizens of the UK at all times. Belgian law permits married couples to modify or change the matrimonial regime defining their property rights during marriage and specifies the procedure for doing so. Decedent and his wife, however, did not execute any

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ATTORNEYS' FEES RECOVERY OF FEES FAIRLY RARE

Bringing and defending lawsuits can be time-consuming and costly. Often during the litigation process, clients wonder why they have to incur the legal costs of filing a claim to recover monies legitimately owed to them or, conversely, defend a claim that seems frivolous. The short answer is that, unlike Britain, the United States legal system generally does not allow parties to a lawsuit to recover their attorneys' fees from the opposing party. This is the "American Rule." In theory, this practice discourages litigants from filing merit-less claims and/or claims for small sums of money. It also frees the courts from having to determine the value of an attorney's services since there is no fixed standard for fees - fee structures can vary widely depending on the case, the client and the attorney(s). In the criminal context, a defendant cannot recoup his attorneys' fees and costs from the government and, in the civil arena, any party involved in a lawsuit is responsible for his or her own fees and costs. There are however exceptions:

1. *Contractual Provisions.* Parties are free to negotiate and enter into contracts which contain attorneys' fee clauses. To be enforceable, the clause must be specific and indicate that the judge "shall" award attorneys fees.
2. *Motion to Compel (Virginia Rule 4: 12(a)4))* – if a motion to compel discovery is granted, the court shall require the party "whose conduct necessitated the motion" to pay to the moving party the reasonable expenses and attorneys' fees incurred in obtaining the court order unless the opposition to the motion was justified.
3. *State Statute*. In some cases a specific statute provides for the recovering of attorneys' fees. Some of the statutory bases for recoupment of attorneys' fees in Virginia are as follows:

a. *Virginia Freedom of Information Act (*Va. Code §2.2-3713) – any person denied "the rights and privileges" conferred by the Virginia Freedom of Information Act shall recover attorneys' fees.

b. *Racial Harassment or Violence* (Va. Code §8.01-42.1) – courts may award attorneys' fees to the prevailing party in a suit for racial, religious or ethnic harassment.

c. *Pleadings* (Va. Code §8.01-271.1) – attorneys fees may be awarded in the event pleadings or other papers are not submitted in good faith or for proper purposes.

d. *Nonsuit* (Va. Code §8.01-380) – attorneys fees may be assessed against the non-suiting party if more than one nonsuit is allowed.

e. *Business Conspiracy* (Va. Code §18.2-500) - persons injured by a business conspiracy may be able to recover attorneys' fees (and treble damages).

f. *Unlawful Interception, Disclosure or Use* (Va. Code §19.2-69) – a court shall award reasonable attorneys fees and costs to any person whose "wire, electronic or oral communication is intercepted, disclosed or used in violation of this chapter…"

g. *Virginia Antitrust Act* (Va. Code §59.1-9.12) - any person injured in his business or property due to violation of the Virginia Antitrust Act may recover fees (treble damages if violation is willful).

h. *Motor Vehicle Warranty Enforcement Act* (Va. Code §59.1-207.14) - a consumer who successfully brings a

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The articles in this publication are designed to give general information on the matters covered. Space limitations prevent exhaustive treatment or analysis of any topic. The articles are not intended to substitute for advice on specific legal problems.

INCOME TAXES

"REASONABLE COMPENSATION" FOR S-CORP SHAREHOLDER-EMPLOYEE

Classic IRS audit redflags include: 1) Failure to report all taxable income; 2) Claiming large charitable deductions; 3) Home office deduction; 4) Business meals, travel and entertainment; 5) Reporting a Small Business Loss; and 6) Math errors and too many round numbers. An additional area of concern for S-Corp shareholder-employees is the "reasonableness" of their employee salary in relation to their shareholder distributions.

Taking a step back, let's review the tax treatments of various business associations. C-Corps are taxed at the corporate level. While S-Corps and LLCs are similar in that they are both "pass-through" entities for tax purposes, the income of these companies are passed through to their owners and reported on the owners' personal income tax returns, thereby eliminating the double taxation incurred by owners of a C-Corp. Consequently, most small businesses are organized as either LLCs or S-Corps. An important factor that differentiates an S-Corp from an LLC is the employment tax that is paid on earnings. The owner of an LLC is considered to be self-employed and, as such, must pay a "self-employment tax" of 15.3% which goes toward Social Security and Medicare. *The entire net income of an LLC is subject to self-employment tax.* In an S-Corp only the salary paid to the shareholder-employee is subject to employment tax. The remaining income that is paid as a distribution is not subject to employment tax. Therefore, there is the potential to realize substantial employment tax savings depending on the classification of income.

So, for the S-Corp shareholder-employee, the question becomes what portion of his business income should he pay to himself as employee salary, subject to employment taxes, and what portion should he receive as distributions, free of employment taxes. While recognizing that Social Security and Medicare are valuable programs and that an individual's benefits under each are in large part based on contributions, it is clear that many S-Corp business owners have an incentive to avoid a "self-employment tax" of 15.3%. Before responding that he should allocate zero to his employee salary, taking all business income as a distribution, be aware that the IRS is aware of this disparate treatment of salary and distributions and actively seeking out abusers. In fact, the quickest way to get audited as an S-Corp is to file an 1120S tax return with no amount showing on Line 7 "Compensation of Officers." Nobody works for free.

The IRS has the ability to recharacterize distributions to the S-Corp shareholder-employee as wages for employment tax purposes. In Revenue Ruling 74-44, the IRS ruled that two shareholders of an electing small business corporation (S-Corp) arranged to receive dividends instead of reasonable compensation for services they performed. That revenue ruling held that the "dividends" constituted wages and were therefore subject to FICA, FUTA and federal income tax withholding. Multiple courts have confirmed the IRS's ability to adjust the employment tax obligations of S-Corps under this theory. *See David E. Watson P.C. v. United States*, No. 4:08-cv-442 (S.D. Iowa 2010) (finding that CPA reporting only $24,000 in salary, while receiving annual distributions of $200,000, had a reasonable annual salary of $91,044, leading to *distributions* of $67,044 being reclassified as wages).

So what should the S-Corp owner pay himself as salary?

Reasonable Compensation. The IRS has provided guidance in Fact Sheet 2008-25. The IRS states therein that there are no specific guidelines for reasonable compensation within the IRS Code or regulations. The IRS further explains that each case is different based on the independent factors as well as the specific nature of the case. Regardless, the Fact Sheet explicitly states that S-Corps should treat payments for services to officers as wages and not as distributions of cash and property, unless they perform no or minimal services. Although we are without specific guidance to determine whether compensation is reasonable, the fact sheet lays out the following as factors that the courts have addressed:

- Training and experience;
- Duties and responsibilities;
- Time and effort devoted to the business;
- Dividend history;
- Payments to nonshareholder employees;
- Timing and manner of paying bonuses to key people;
- Payment by comparable businesses for similar services;
- Compensation agreements; and
- The use of a formula to determine compensation.

In short, reasonable compensation is commensurate with the services you are adding as an employee of the company. On one extreme, in a one-man-shop services company (*e.g.,* CPA, website developer, attorney, tailor, etc.) it is hard to argue that 100% of the income is not wages, or self-employment income. As you add partners, employees and contractors it becomes less clear what portion of your share of the income is rightfully classified as wages/salary and what portion should be distributions of business income. Therefore, it is important to consider a number of factors, including those listed above, in setting reasonable compensation for shareholder-employees of an S-Corp. Those intent on pushing the envelope would be well advised to have their accountant's and attorney's numbers on speed dial.

JUSTIN BANFORD

EMPLOYMENT

FEDERAL COURT BACKS EMPLOYER IN NON-COMPETE CASE

In a classic, or stereotypical, *non-compete* case, the dominant employer seeks to hammer the former employee who had the temerity to take his skills (and maybe a few customers) to a competing business. Because of the inherent anti-competitive nature of the one-sided agreements that underlie such disputes, courts often hold plaintiffs to a high standard of proof, harshly imposing a litany of disqualifying interpretative standards to narrow or even vitiate the agreement at issue.

While non-competes are not favored by Virginia courts in the typical employer-employee situation, a non-compete provision born of an arms-length transaction among bargaining equals may be another matter. In the recent case of *McClain & Co. v. Carucci*, No. 3:10cv00065, the U.S. District Court for the Western District of Virginia ruled that a non-compete of this sort must merely be "reasonable" to be enforceable.

Plaintiff McClain & Co. sued its former regional marketing manager Carucci for breaching a non-compete agreement he had accepted as part of a settlement of an earlier dispute concerning alleged embezzlement of approximately $285,000 by Carucci. Under terms of that agreement, Carucci was to repay $250,000 and agree not to compete with McClain in its traffic control and equipment business. Allegedly, Carucci promptly set up a new business, MPT, to compete directly with McClain.

The Court denied Carucci's motion to dismiss the breach of contract claim, finding the allegations sufficiently specific under Rule 8 of the Federal Rules of Civil Procedure. The Court noted that MPT started business just a few days after the McClain-Carucci agreement had been reached, that MPT and Carucci shared a phone number, that MPT's advertising puts in squarely in McClain's space and that it owns equipment similar to McClain's. The Court found it "plausible" that the non-compete had been breached, so defendant's motion to dismiss was denied.

The Court declined to critically assess the challenged non-compete, explaining that the restricted party here did not merit the same deference as in a typical employer-employee dispute: "This difference in standards is justified by the fact that employees often have comparatively little bargaining power and less leverage for negotiating a fair deal, while the sale of a business more typically involves sophisticated parties coming to an agreement after an arms-length negotiation process."

LAWRENCE CARR

INTERNATIONAL TAX

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documents in Belgium requesting their marital property regime be changed to community property. In 1985 decedent made a will, leaving his property to his wife and two children in equal shares. In 1997 decedent purchased 50,000 shares of Citigroup, a U.S. corporation, and held the stock in his name.

On the alternate valuation date the Citigroup stock was worth about $8 million. Since Citigroup is a U.S. corporation, its stock is U.S. situs property and decedent's estate was taxed on that stock with only a $60,000 exemption. The executor filed a U.S. estate tax return claiming the stock was community property, reporting $4 million as the taxable value of the stock, and paid an estate tax of about $1 million. The Internal Revenue Service (IRS) determined a deficiency in the Federal estate tax in the amount of $2 million on the basis that the whole amount was taxable as decedent's separate property. The estate appealed to the Tax Court, which affirmed the IRS. The Court of Appeals in turn affirmed the Tax Court.

Both the Tax Court and the Court of Appeals decisions contain long, soporific discussions of the Conflict of Laws principles applicable to this case. Suffice it to say that because decedent and his wife had never changed their property regime to Belgian community property, the English separate property regime applied to them as UK nationals. By failing to execute some simple papers in Belgium the estate tax bill was $3 million instead of $1 million.

Moreover, the estate tax bill could have been easily reduced to zero had decedent formed a Belgian or other foreign corporation which in turn purchased the Citigroup stock. Stock in a foreign corporation is a non-U.S. situs asset in the hands of a nonresident, nondomiciliary, even if all the assets held by the foreign corporation have a U.S. situs. Thus, a foreign corporation is the ideal vehicle for nonresident aliens to hold U.S. real property or the stock of U.S. companies.

As demonstrated by the simple facts of this case, estate planning is not rocket science but lack of planning can be prohibitively expensive.

NÉSTOR CRUZ

ATTORNEYS' FEES

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lemon law claim shall recover fees.

i. *Trade Secret Act* (Va. Code §59.1-338.1) – court may award fees if misappropriation of trade secrets was willful and malicious or a claim for misappropriation was made in bad faith.

j. *Consumer Protection Act* (Va. Code §59.1-204) – attorneys' fees may be awarded to any person who suffers loss as the result of a violation of the Virginia Consumer Protection Act.

4. *Federal Statute.* Federal statutes may also provide a basis for recovery of attorneys' fees. For example, the Sherman Antitrust Act, the Clayton Antitrust Act, the Lanham Trademark Act and the Copyright Act provide that courts may award attorneys' fees in specific instances.

There are a couple things to keep in mind. Even if you are within one of the exceptions above, you generally have to "win" or be the prevailing party to recover fees. Judges are also reluctant to award attorneys' fees and, even when contractually and/or statutorily required to do so, judges will only award "reasonable" fees – regardless of what was actually billed.

DANA THERIOT

CARR, MORRIS & GRAEFF, P.C.

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

The firm strives to provide full service representation to its corporate and individual clients. It is designed to provide such service by organization and presentation of an array of attorneys with diverse backgrounds in specialized areas of the law as well as a generalized background which enables them to look beyond a narrow specialty or need. The academic and cultural backgrounds of the attorneys of the firm are as diverse as their experience and specializations.

Carr, Morris & Graeff, P.C., specializes in the following areas: Corporate/General Business; Taxation/Estate Planning; Civil/Commercial litigation; Employment/Labor; Discrimination and Wage-Hour; Criminal; and Alternative Dispute Resolution.

The firm maintains its office in Tysons Corner, Virginia—the business hub of the metropolitan region. It has attorneys admitted to all of the local judicial jurisdictions.

STAFF NOTES

After a more characteristically mild Washington winter, we feel guilty even thinking of Summer vacations…but we'll get over it. Where is everyone headed?

- Roy Morris: Roy and Marie have a bicycling summer planned. In June, they will spend a week bicycling the Blue Ridge Parkway and visiting Virginia historical sites. Their companions for this trip will be a New York couple they met while bicycling Greece.

  In September, they will spend 10 days by bicycle riding the pilgrimage route in Northern Spain known as El Camino de Santiago. In the year 814, according to legend, a shower of falling stars guided the Spanish hermit Pelayo to Santiago, where he discovered the long-forgotten tomb of the apostle St. James. Since that time, the road to Santiago has been a pilgrimage route. It is said to be a spiritual experience for all participants.

  Roy and Marie are feverishly trying to get in shape and, so far, it's a lot harder than it looks. They are only up to 38 miles in a day, whereas there was a time when they could knock off 100 miles days.
- Steve Graeff: books, bottles of wine and cocoa butter at a beach TBD.
- Larry Carr: a little beach time…and unpacking from a recent house move.
- Dana Theriot: Corolla's loss is Virginia Beach's gain…the amusement sites and kid-friendly restaurants of the Outer Banks take a major hit as Dana moves her crew to a new beach.
- Phil Schwartz: The economy of OBX rebounds as Phil takes his family to Duck.
- Justin Banford: hedging his bets against end-of-the-world predictions, Justin and Jill went early—to Seattle, Vancouver et al to tour, visit family…getting in touch with his Canadian roots.
- Nestor Cruz: Boca, Boca, always Boca…the swallows returning to San Juan Capistrano are less predictable than Nestor to Boca.
- Tom Berger: Once again, boating in the Chesapeake…although there is some debate whether "boating in the Chesapeake" is code for "partying at a dock in Baltimore."

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