

LEGAL UPDATE

CLIENT NEWSLETTER OF CARR, MORRIS & GRAEFF, P.C.

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LITIGATION

VIRGINIA'S INSULTING WORDS STATUTE

In addition to claims for defamation, a cause of action based on Virginia common law, individuals who have been on the receiving end of provocative insults or statements may also be able to bring suit under Virginia's "Insulting Words Statute." The Insulting Words Statute, found at Virginia Code 8.01-45, provides that: "All words shall be actionable which from their usual construction and common acceptance are construed as insults and tend to violence and breach of the peace." Originally created to prevent duels, this statute is now utilized in situations "to discourage offensive and excessive freedom in the use of that unruly member, the tongue..."

Virginia courts rely heavily upon and utilize principles of defamation in deciding cases based upon the Insulting Words Statute. For example, both causes of action require that the allegedly insulting or defamatory statement be false. In *Walker v. Harrison*, the Circuit Court of the City of Salem stated that while the Defendant Harrison used "curse words and gutter language during the course of the altercation... these words cannot be understood to convey a false representation of fact. The words used, although uncivilized and offensive, do not

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TAX

REASONABLE COMPENSATION—PART IV

In Part III of this article, we discussed *reasonable compensation* in the context of S corporations and Limited Liability Companies (LLC's). In this article we discuss a recent court case which operationalizes the principles discussed in Part III with respect to S corporations. S corporations are flow-through entities, so there is only one level of taxation. However, that portion of employee-shareholder compensation deemed to be salary is saddled with payroll taxes of 6.2% for Social Security up to a certain annual limit and 1.45% for Medicare with no annual limit. The employer corporation pays another 6.2% and 1.45%, so the burden on the employee-shareholder is really 15.3% of salary payments.

It is thus to the advantage of employee-shareholders to minimize salary payments and avoid payroll taxes. Any salary payment above the upper limit for Social Security tax will not result in an increased annuity for taxpayer after retirement (assuming Social Security is even solvent at the time) but will result in an extra 2.9% of Medicare tax. Moreover, if the employee-shareholder is a good investor, he or she might end up with a larger overall retirement income by taking less in salary, thus receiving a lower Social Security annuity, but investing the payroll tax savings wisely.

Needless to say the Internal Revenue Service (IRS) does not look kindly on such manipulation. In evaluating *reasonable compensation* in the S corporation context, the IRS and the courts will consider the same factors as in the C corporation context, except they will be looking for compensation which is abnormally low rather than abnormally high. A good place to start is the upper salary limit for Social Security tax, \$106,800, in 2010. A CEO of a profitable company who makes much less than this amount is probably earning an unreasonably low salary.

In *David E. Watson, P.C. v. United*

States of America, Case 4:08-cv-442, U.S. District Court for the Southern District of Iowa, May 27, 2010, Plaintiff Watson was a Certified Public Accountant (CPA), with a master's degree in Taxation and ten years of experience at Ernst & Young, a top CPA firm. In 1996 he incorporated DEWPC as an Iowa Professional Corporation and elected to be taxed as an S corporation. Watson has been its sole shareholder, employee, director, and officer. As such, he had complete control over the flow of money through DEWPC. "At shareholder meetings Watson held with himself in 2000-2002, Watson authorized for himself a salary from DEWPC in the amount of \$24,000 annually." [Emphasis supplied]

Tax years 2002 and 2003 were in dispute. In 2002, in addition to his \$24,000 salary, Watson received a dividend of \$118,000. In 2003, in addition to his \$24,000 salary, he received a dividend of \$222,000. In both years Watson worked between 35 to 45 hours per week 46 weeks per year. His monthly living expenses exceeded his \$2,000 salary. In 2007 the Service assessed additional taxes plus penalties and interest against DEWPC for 2002 and 2003. Specifically, the IRS contended that \$67,000 of each year's dividend distributions should be recharacterized as wages for those years, for a total of \$91,000 of wages for each year. (It is significant that in 2002 the wage base for Social Security was \$84,900 and in 2003 it was \$87,000.)

Plaintiff Watson paid the assessment and filed a claim for a refund with the IRS, which was denied. He then sued Defendant IRS and moved for summary judgment. The court denied the motion, reasoning as follows: The owners of S corporations have the incentive to "alchemize salary into earnings." A corporation has to pay employment taxes, such as state unemployment insurance tax and Social Security tax, on the salaries it pays. An S corporation can avoid paying them by recharacterizing salary as a distribution of corporation income. The courts consider several factors in determining reasonableness

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BUSINESS/TAX WITHHOLDING TAX PENALTIES

Employers report employee federal tax withholdings and the employer and employee shares of the Social Security (FICA) and Medicare tax on IRS Form 941. Depending on the size of the employer's tax liability, employers are required to submit tax deposits on a monthly, semi-weekly basis or next-day basis. The Form 941 must be filed quarterly. As explained below, the penalties for non-compliance are substantial. Thus, it is important that all employers timely file the Form 941 and that all taxes are paid when due.

The IRS imposes two separate penalties which relate to Form 941 and the payment of taxes reported on Form 941. The first penalty addresses the *failure to file* Form 941 on time. As the Form is filed quarterly, it must be filed by the last day of the month following the close of each calendar quarter. Thus, the Form for the first quarter of a year (the period of January through March) is due April 31. The IRS assesses a penalty equal to 5% per month on the balance due on the return for each month (or partial month) the return is late. This late filing penalty is capped at 25% of the balance due on the return.

The second penalty imposed by the IRS relating to Form 941 is the *failure to deposit* penalty. This penalty is imposed if the employer fails to make its tax deposits (pay to the U.S. Treasury the employee federal tax withholdings and the employer and employee share of the Social Security tax and Medicare Tax) when due. Failure to deposit penalties range from 2% to 15% and will continue to accrue until the tax is paid. For deposits one to five days late, the penalty is 2% of the tax due. Deposits six to 15 days late incur a 5% penalty and deposits 16 or more days late incur a 10% penalty. Lastly, deposits delinquent more than 10 days after receipt of a notice from the IRS relating to the tax incur a penalty equal to 15%.

As the penalties are severe, employers are urged to timely file Form 941 and to deposit all payroll taxes when due.

PHILIP SCHWARTZ

ESTATE PLANNING REVISED FREQUENTLY ASKED QUESTIONS

—PART II

Continued from the last edition, here is the remainder of our FAQ section for estate planning clients. Please contact us if you would like to have the entire FAQ section sent to you. Enjoy.

Frequently-Asked Questions about Estate Planning – Part II

Life insurance and retirement accounts

13. What assets pass outside the will and trust?

The three most important classes of property that pass outside the will and trust are life insurance, retirement accounts [401(k), IRA, TSP, etc.], and any property held in joint names with survivorship, such as real estate and bank and brokerage accounts. In unplanned estates it is not unusual for virtually all assets of the first spouse to die to pass by virtue of either beneficiary designations or joint title.

14. Who should own my life insurance and who should be the beneficiary?

If we prepared an irrevocable life insurance trust ("ILIT") as part of your estate plan, the ILIT should be both the owner and beneficiary of the policy. Otherwise, name your spouse or life partner, adult children or living trust depending on your objectives.

15. Who should be the beneficiary of my IRA, 401(k) and other retirement plan accounts?

Spouses have the widest range of roll-over and deferral options with respect to inherited retirement plans, so one's spouse is normally the best choice, absent special family dynamics. Other beneficiaries must begin required minimum distributions based on their life expectancy. The secondary beneficiary should usually be your living trust.

Reviewing and changing your estate plan

16. Can I change any of this if I need to?

Yes, you can amend your will or living trust at any time. The only documents you cannot change are *irrevocable* trusts—the most common of which are to hold life insurance.

17. How often should I review my estate plan?

A review is appropriate whenever you experience life-changing events, such as the birth of a child, separation from a spouse, disability or terminal illness, death of a family member, or major changes in your finances or in the estate tax law. Absent these events or changes in your intentions, every five years is a good rule of thumb. Estate planning is an evolving process, not an event. The plan will need to change over time to adapt to life and legal changes.

18. What if I get divorced/married/have more children?

Marriage and divorce entail special legal rights which may supersede your estate plan. Generally, estate plans we prepare anticipate additional children; but, as mentioned above, any of these events may require modifications to your estate plan.

19. Will you notify me of any changes in the law affecting my estate plan?

The federal estate tax is subject to frequent major revisions. Our engagement is limited to the preparation and implementation of a plan meeting your present objectives. We do not undertake to keep you advised of tax law changes which may affect your plan. We do keep clients posted on changes through our newsletter, *Legal Update*, and you can always call us if you have questions.

20. What if my name or the name of a representative or beneficiary changes?

As long as the reader of the will knows who the person is (*e.g.*, my sister Glenda), it's not necessary to amend the will just to reflect subsequent name changes occasioned by marriage or divorce.

21. Do I need a new will if I move to another state?

Usually, no. A will made while a resident of one state will be valid and recognized by any other state. If you are married and you move to a community property state (Arizona, California, Idaho, Nevada, New Mexico, Texas, Louisiana or Washington), you will need to review your situation, particularly if one spouse has children from a prior marriage.

ROY MORRIS & JUSTIN BANFORD

ARBITRATION**VALIDITY OF ARBITRATION PROVISION IS FOR COURT TO DECIDE**

Typically, in a lawsuit arising from a contract that has a mandatory arbitration provision, the court will *stay* the proceeding and order the parties to arbitration. Procedural issues regarding the *arbitrability* of the dispute are left to the arbitrator. In the recent case of *Keeton v. Wells Fargo Corp., et al.*, D.C.C.A. No. 08-CV-990 (Jan. 21, 2010), the District of Columbia Court of Appeals confronted a variation on the usual situation and clarified the trial court's role in dealing with arbitration agreements.

The underlying dispute in *Keeton* concerned a commercial scenario that certainly fits the stereotype. A used car dealer sold a vehicle to an unsophisticated buyer for a price well above fair market value, arranging financing through the named party, Wells Fargo. Predictably, the car didn't hold up, the buyer missed payments, the vehicle was repossessed and sold for a loss, and Wells Fargo sued for the balance. Ms. Keeton counter-sued for fraud and misrepresentation, arguing the sale contract was unconscionable. The dealer and bank defended by seeking enforcement of the arbitration clause of the agreement, and the trial court dismissed with prejudice.

Procedurally, the appellate court had jurisdiction because the trial court, rather than merely staying the case, had dismissed it with prejudice. Since that amounts to a final determination, the issue was appropriate for appeal.

Turning to the merits the Court of Appeals reversed the trial court and returned the case for development of a factual record. The Court explained that, "[O]ur well-settled unconscionability standard calls for a strongly fact-dependent inquiry." Ms. Keeton had challenged the contract itself as an unconscionable *adhesion* contract. The parties had argued about the commercial choices Keeton may have had—the sort of issue addressed in assessing unconscionability—but no evidentiary record had been developed. The Court of Appeals ruled that development of such a record, and a determination of contract validity based on that record, is a matter for the court, not the arbitrator.

LAWRENCE CARR**LITIGATION***Continued from page 1*

rise to the level necessary to sustain a cause of action for defamation and similarly a claim under the Insulting Words Statute." Similarly, in *Crawford v. United Steelworkers*, the Supreme Court of Virginia court found that while certain "disgusting, abusive, repulsive" words were used during a heated labor dispute, these words or name-calling could not reasonably be understood, in the context in which they were used, to convey a false representation. Accordingly, there could be no claim under §8.01-45.

The Insulting Words Statute does, however, impose an additional requirement. To bring a claim under the statute, the insulting words must also be *provocative*. The Virginia Supreme Court has held that it will apply the plain meaning of clear and unambiguous statutes such as §8.01-45 and, therefore, only statements that "tend to violence and breach the peace" are actionable. In *Allen & Rocks v. Dowell*, the Virginia Supreme Court found that an employer's negative and critical comments about a former employee to a third party could not be construed as provoking violence or breaching the peace. However, in *Trail v. General Dynamics*, the United States District Court for the Western District of Virginia denied the defendants' motion to dismiss and held that the Plaintiff had stated a *prima facie* case under the Insulting Words Statute and could proceed with her case. In that matter Ms. Trail alleged that her former employer, General Dynamics, violated the statute by publicizing a newspaper article which contained information about her criminal indictment via mass distribution to other employees and management, suspended her without pay and, ultimately, terminated her in a letter that accused her of "unethical and criminal activity despite reassurances from the prosecutor that Trail would not face criminal charges." The District Court stated that it was reasonable to infer that these activities could "lead to violence" and "could lead to a breach of the peace." Virginia courts have repeatedly found that false accusations regarding crimes and/or criminal conduct are insulting and can give rise to claims under the statute.

Virginia courts have also applied the Insulting Words Statute to claims stemming from either verbal or written statements.

There does not have to be a face-to-face confrontation. Unlike libel or slander (forms of defamation), though, an insulting words claim does not require publication of the statement in question. Rather, the statement may be actionable if it is uttered only to the plaintiff.

DANA THERIOT**TAX***Continued from page 1*

of compensation, among them: employee's qualifications, extent and scope of work, and prevailing rates of compensation for comparable positions.

The court held that, contrary to Plaintiff's assertion that DEWPC "clearly documented its intent to pay \$24,000 in salary to Watson," consideration of evidence other than corporate documentation gives rise to an equally reasonable inference that DEWPC structured Watson's salary and dividend payments in an effort to avoid Federal employment taxes, with full knowledge that dividends paid Watson were actually "remuneration for services performed." Indeed, intent often must be inferred from the totality of the circumstances, as one would hardly expect a corporate entity to thoroughly document an actual intent to avoid Federal employment taxes by disguising remuneration as dividends.

In sum, the salary of \$24,000 Plaintiff assigned himself was ludicrously low considering he was a CPA with a master's degree and ten years of experience with a top firm. The salary the IRS imputed, \$91,000, was well within the range of salaries for CPA's with Plaintiff's qualifications and experience. In its conclusion the court cited two of America's finest judges by stating that, while it is true that "nobody owes any public duty to pay more [tax] than the law demands" (Learned Hand), it is equally true "taxes are what we pay for civilized society" (Oliver Wendell Homes). On a more down-to-earth and pragmatic level, we can expect the Service to pursue these cases and the courts to side with the IRS not only because of the legal principles involved, but also because both Medicare and Social Security are insolvent. Moreover, the latest medium term projections on the Federal budget deficit from the Congressional Budget Office are scary.

NÉSTOR CRUZ

**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

Roy Morris recently made a presentation on *Partnership Breakups* to the D.C. chapter of the Entrepreneurs' Organization.

* * *

As we go to press, Roy Morris and his family are bicycling the mountains of the Provence region of France.

* * *

Margarita and Néstor Cruz extended their Boca vacation by flying with some old friends to Casa Grande in the Dominican Republic.

* * *

Phil Schwartz was part of a foursome that brought home the first place trophy in a recent fundraiser golf outing at Arnold Palmer's Latrobe Country Club....*Phil scorched the course but refrained from offering Arnie any tips when they met for photos and autographs after golf.*

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