

THE GOVERNMENT CONTRACTOR®



Information and Analysis on Legal Aspects of Procurement

Vol. 48, No. 7

February 22, 2006

Focus

¶ 61

Shareholder Taxes On Dividends Are Not Allowable Costs For Subchapter S Corporation, Federal Circuit Holds

Information Sys. & Networks Corp. v. U.S., Nos. 04-5151 & 5154 (Fed. Cir. Feb. 6, 2006)

State income taxes paid by the sole shareholder of a subchapter S corporation and reimbursed by the corporation are not allowable costs on the corporation's cost-reimbursement contracts, the U.S. Court of Appeals for the Federal Circuit has held. Under Federal Acquisition Regulation 31.205-41, state taxes from which the contractor is exempt are not allowable costs. The corporation was not required to pay tax on the shareholder's dividend and, therefore, was not entitled to reimbursement of those costs.

Information Systems and Networks Corp. (ISN), a subchapter S corporation under 26 USCA § 1362(a), has cost-reimbursement contracts with the Government. Subchapter S status allows small businesses to incorporate, without incurring the double taxation that occurs when traditional corporations pay tax on their income, and shareholders pay tax on dividends. Under the tax code, subchapter S corporations are exempt from federal income tax; only the shareholders pay taxes on dividend income.

Many states have adopted the same tax treatment of subchapter S corporations. In those states, ISN does not pay state tax on its income. Instead, the company's sole shareholder pays tax on ISN dividends.

ISN included its shareholder's state tax payments in its requests for reimbursement under Government contracts. Because ISN's subchapter S sta-

tus exempted it from state income taxes, the Government determined that the shareholder's state income tax payments were not allowable costs and refused to reimburse ISN under its cost-reimbursement contracts.

ISN successfully challenged that decision at the U.S. Court of Federal Claims, which determined that the state income taxes qualified for reimbursement under FAR 31.205-41, governing allowability of federal, state and local taxes. The COFC relied on FAR 31.205-41(a), which states, "except as otherwise provided in paragraph (b) ...," state taxes are allowable if they "are required to be and are paid ..." Under FAR 31.205-41(b)(3), "taxes from which exemptions are available to the contractor" are not allowable. That provision further states that the "term 'exemption' means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise." The COFC held that "the state income taxes were required to be paid and were paid, and because the tax liability on the corporate income was not subject to *abatement or reduction*, the state income taxes claimed by [ISN] for reimbursement are allowed under the [FAR 31.205-41]" (emphasis added). See *Info. Sys. & Networks v. U.S.*, 48 Fed. Cl. 265, 270 (2000).

On appeal, the Federal Circuit rejected the COFC's narrow interpretation of FAR 31.205-41(b), and held that the regulation makes clear that "exemption" means "freedom from taxation in whole or in part." After setting that standard, FAR 31.205.41(b) states that " 'exemption' ... includes a tax abatement or reduction." The Federal Circuit concluded that nothing in FAR 31.205 supports the COFC's interpretation that "exemption" is limited to tax abatements and reductions. Rather, these are "only two examples" of exempt taxes.

The Federal Circuit also rejected the COFC's holding that the shareholder's taxes "were required to be paid and were paid," and thus allowable under FAR 31.205-41(a). This interpretation is wrong because allowability under FAR 31.205-41(a) applies to taxes paid by the contracting entity. Only ISN's

shareholder paid state income taxes on her dividends from ISN. Because the shareholder is not the contracting entity, FAR 31.205-41 does not apply to her tax payments.

The COFC's analysis of state taxation of subchapter S corporations did not support the COFC's holding that the taxes were allowable, the Federal Circuit said. The COFC noted the important relationship between a subchapter S corporation and its shareholders in the state tax codes at issue. The COFC also found that, generally, "the state tax codes explain that any corporation which fails to pay its state income taxes, no matter what tax election status it holds, will be subject to penalty and encumbrance on its ability to do business with the state." The Federal Circuit disagreed on the significance of this analysis and ruled that state statutory requirements do not demonstrate the allowability of shareholder tax payments. In addition, the analysis suggests that the costs are unallowable under FAR 31.205-15, which makes fines and penalties unallowable, the Federal Circuit said.

The Court concluded that the "plain language of [FAR 31.205-41(b)] states that taxes from which the contracting entity is exempt are not allowable costs." ISN, the contractor here, "is free from taxation" on the shareholder's ISN dividend income, and those tax payments are not an allowable cost for ISN.

◆ **Practitioner's Comment**—The Federal Circuit's holding probably is not a surprise. As the COFC decision acknowledges, S corporations are not themselves subject to tax. For that reason, it is a close question whether an S corporation's reimbursement of its shareholder for paying the corporation's transferred tax liability is an allowable cost under FAR 31.205-41. Nevertheless, the rationale, if not the holding, of the Federal Circuit's decision is disappointing because the Court seems to have missed the point of the COFC decision.

The costs of federal, state and local taxes, with the exception of federal income taxes, are generally allowable for Government contract purposes, provided they "are required to be and are paid or accrued in accordance with generally accepted accounting principles." FAR 31.205-31(a)(1). Accordingly, if ISN were a "C" corporation instead of an "S" corporation, there would be no question that its state income taxes are allowable costs. A C corporation, in contrast to an S corporation, distributes *after-tax* income to its shareholders, and the shareholders pay taxes only on their

personal income. An S corporation distributes *pre-tax* income to its shareholders, and the shareholders, rather than the corporation, pay taxes on the *corporate* income as well as their personal income. Thus, as the COFC correctly observed, ISN, "as an S corporation, is not relieved of state tax liability, but is simply required to pass its liability on its corporate income" to its sole shareholder. The net result of the Federal Circuit's decision is that if ISN were a C corporation and paid its taxes directly, the costs would be allowable, but because ISN is an S corporation and passed through its tax liability to its sole shareholder, and then reimbursed her for the cost of paying the taxes, the costs are unallowable.

The Federal Circuit ignored the "important and intermingled" relationship between an S corporation and its shareholders, focusing instead on two aspects of the COFC's decision taken somewhat out of context. First, the Federal Circuit took issue with the lower court's interpretation of FAR 31.205-41(b)(3), which makes unallowable "[t]axes from which exemptions are available to the contractor directly, or available to the contractor based on an exemption afforded the Government" The COFC concluded, quite reasonably, that while "technically [ISN] is 'exempt' from paying state income taxes due to its S corporation status, this is not a tax exemption in the normal sense of the term." The COFC decision explains that, unlike a normal exemption, which results in freedom from tax, an S corporation election results in a transfer of liability to the corporation's shareholders. Focusing narrowly—and somewhat unfairly—on the COFC's use of the terms "abatement" and "reduction," the Federal Circuit held that the COFC "incorrectly concluded that, because the state income tax was not a tax reduction nor a tax abatement, the state income tax liability could not be an exempt tax under 48 C.F.R. § 31.205-4(b)."

The Federal Circuit gave equally short shrift to the COFC's observation that S corporations may be liable for penalties if their shareholders do not pay the passed-through taxes. The COFC decision uses these penalties to illustrate that the taxes paid by an S corporation's shareholders are the transferred liability of the corporation. All but ignoring this point, the Federal Circuit reasoned that the fact that an S corporation may be subject to penalties if its shareholders do not pay the taxes is not enough to establish that the tax liability of the shareholder is an allowable cost of the corporation. Then, citing

FAR 31.205-15(a), the Federal Circuit concluded that the COFC's description of the state tax liabilities as penalties "suggests that these costs are generally not allowable costs." That one may be subject to penalties for not paying a cost does not render the cost a penalty. Thus, FAR 31.205-15 is wholly irrelevant to the allowability of ISN's state tax reimbursements.

In summary, setting aside the issue of whether the holding is right or wrong, the Federal Circuit's decision could be improved by more meaningfully addressing the lower court's rationale.



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