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Tax Treatment for Post-Retirement Payments

Xiaoyue Tan
San Jose State University

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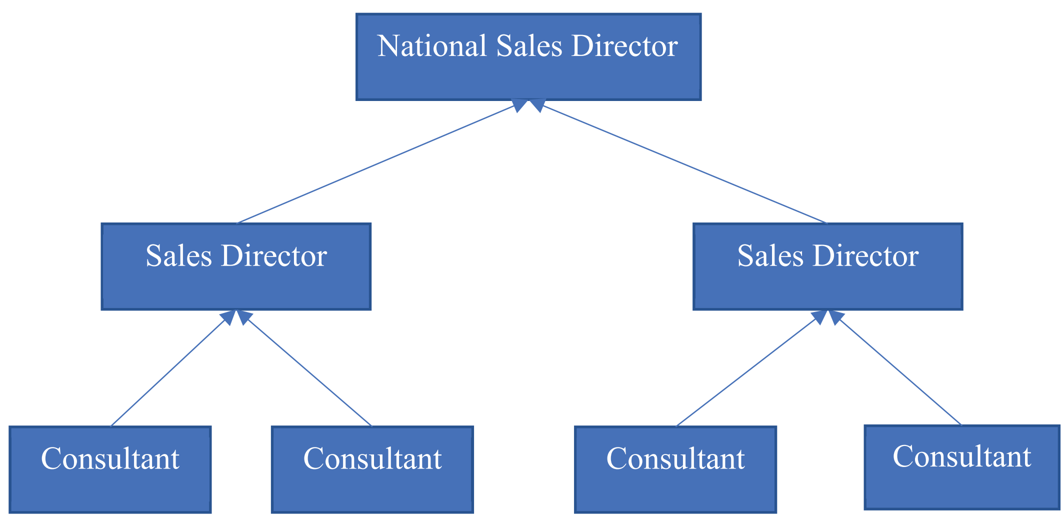
By: Xiaoyue Tan, MST Student

When there is established precedent, can a taxpayer reach a different result? On February 18, 2020 the Tax Court held that Eileen Dunlap, an ex-national sales director of Mary Kay Cosmetics, Inc., was subject to self-employment (SE) tax on her post-retirement payments from Mary Kay.[1]

Background

Mary Kay Cosmetics, Inc. is a manufacturer and seller of cosmetics and related products. Ms. Eileen Dunlap was a Mary Kay beauty consultant and worked as a salesperson independent contractor. She purchased products at wholesale prices from Mary Kay and resold them at retail prices. She received commissions and bonuses from Mary Kay for the products she sold. With excellent sales skills, she became a sales director in 1981. As a sales director, she recruited and trained beauty consultants to sell Mary Kay products. She received commissions and bonuses based on the sales of the consultants in her tier. Mary Kay made monthly payments to its independent contractors, like Dunlap, and no taxes were withheld from the payments. If one of her consultants stop working for Mary Kay, Dunlap's monthly payment was reduced. Dunlap and the consultants she recruited had agreements with Mary Kay that set forth their duties, rights, and commission structure.

Once Dunlap recruited a certain number of sales directors, she was promoted to national sales director in 1988. She had sales directors and consultants in her tier but had no direct authority over them. Mary Kay did not have an employer-employee relationship with their national sales directors, sales directors, and consultants. The flowchart below is Mary Kay's operational structure.



[1] Dunlap, T.C. Summary Opinion 2020-10 (2/18/20).

As a national sales director, Dunlap could participate in the Family Security Program (FSP). FSP provided national sales directors with financial security when they retired. Under FSP, Dunlap's contractual relationship with Mary Kay would be terminated when she turned 65. She would then begin to receive 15 years of FSP payments based on her average sales activity as well as her tier's average sales activity. In January 2006, she was eligible to receive FSP payments. Under the agreement, she was entitled to 60 percent of her final average of commissions during her last 15 years of service. The FSP agreement stated that she was not an employee of Mary Kay.

A preamble to a July 1, 1991 FSP restatement was specifically prepared for Dunlap:

> [E]ach National Sales Director desires to participate in this program in exchange for the offer by Mary Kay Cosmetics, Inc. to acquire at retirement the valuable goodwill and all other rights associated with the business, including future goodwill generated by her continued support and loyalty to Mary Kay Cosmetics, Inc.

The FSP program was funded by the general assets of Mary Kay. The FSP statement clearly stated that the plan was intended to be a non-qualified deferred compensation arrangement. It was not a qualified pension, profit-sharing, or stock bonus plan formed for the exclusive benefit of its employees or their beneficiaries. Dunlap remained retired during 2014 and 2015 and did not have any other trade or business during those years. The IRS determined that she had income tax deficiencies for 2014 and 2015 tax years because she had mistakenly reported the FSP payments as ordinary income rather than as net earnings subject to self-employment.

The sole issue before the Tax Court was whether FSP payments received by Dunlap were subject to self-employment tax.

Self-Employment Tax

Self-employment tax is the key point in this case. SE tax is imposed on the net earnings from self-employment. Reg. 1.1402(a)-1(c) defines net earnings from self-employment:

> Gross income derived by an individual from a trade or business includes gross income received (in the case of an individual reporting income on the cash receipts and disbursements method) or accrued (in the case of an individual reporting income on the accrual method) in the taxable year from a trade or business even though such income may be attributable in whole or in part to services rendered or other acts performed in a prior taxable year as to which the individual was not subject to the tax on self-employment income.

In other words, SE income for the current year includes income received by a cash-basis individual. It also includes income accrued by an accrual-basis individual in the current tax year from a trade or business, even though the income may be attributed in whole or in part to work or services performed in earlier tax years. In this case, the FSP payments Dunlap received from Mary Kay were fixed based on the average tier sales activity before retirement. Therefore, Mary Kay's FSP payments to Ms. Dunlap clearly were subject to self-employment tax.

Danielson Rule

The IRS relied on *Peterson v. Commissioner* [2] as precedent to support that the FSP payments Dunlap received were subject to the SE tax. In the *Peterson* case, all important facts were the same as those of the *Dunlap* case. Ms. Peterson was also a national sales director who entered an FSP agreement with Mary Kay and received FSP payments. Peterson argued that the FSP payments were made in exchange for the sale of her business back to Mary Kay. However, the Tax Court decided that the FSP payments were subject to SE tax instead of capital gain tax. The Court of Appeals for the Eleventh Circuit affirmed th court's opinion. There are only two differences in these cases: their retirement year and the Circuit they reside in. Peterson retired in 2009 but Dunlap retired in 2006. For the *Peterson* case, the Court of Appeals for the Eleventh Circuit affirmed the Tax Court's opinion whereas Dunlap resided in the Ninth Circuit.

Ms. Dunlap argued that she should not be bound by the holding of the *Peterson* case because her FSP terms were different from Peterson's. She used the preamble text in the 1991 restatement which supported her argument that she sold her business or goodwill to Mary Kay and that the FSP payments were for the sale of a capital asset. Therefore, the FSP payments should be subject to capital gain tax instead of SE tax. She claimed that the preamble text in the 1991 restatement prove that Mary Kay FSP payments were made in exchange for her business and valuable future goodwill generated by her continued support and loyalty to Mary Kay.

The court referred to the *Danielson* rule:

> a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties [to the agreement] would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, et cetera.[3]

To show that her case is different from the *Peterson* case, Dunlap must present valid evidence according to the Danielson rule. However, there was no agreement between Mary Kay and Dunlap with respect to any sale of a business or goodwill. Except the preamble to the 1991 restatement, there was no evidence in the record that would support a sale of business or goodwill.

Conclusion

Judge Gerber held that the FSP payments Ms. Dunlap received from Mary Kay were subject to SE tax. The FSP payment amount was based on the quantity and quality of her prior labor, which was fixed. She failed to prove that her case was different from the *Peterson* case because there was a lack of a written agreement. A taxpayer needs to provide proof of different facts or legal interpretation to challenge tax consequence when there is precedent. Also, because Dunlap's case is a "small claims" one in Tax Court, there is no ability for her to appeal the decision to the Ninth Circuit Court and the case cannot be treated as precedent for any other case. [4]

[2] Peterson v. Commissioner, 827 F.3d 968 (11th Cir. 2016), aff'g T.C. Memo. 2013-271.
[3] Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967).
[4] Section 7463(b).