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S Corporations, Payroll Taxes and Closing Loopholes

By Robert W. Wood • Wood & Porter • San Francisco

Remember the 2004 John Edwards presidential campaign? Long before his 2008 campaign, the stage entrance of Rielle Hunter and talk of a love-child, there was talk of taxes. As the primary shareholder in a large and successful personal injury law practice, Mr. Edwards was famously paid a relatively modest salary by his S corporation. He then received the bulk of his pay (in the millions) *via* a dividend distribution. Tax professionals were titillated by the way in which S corporation owners could avoid payroll taxes.

This issue was not the subject of political furor, but it did generate an epistolary debate among tax practitioners. The consensus of that debate seemed to be that this practice was perfectly reasonable, depending of course on the size of the salary payment and its "reasonableness." "Reasonableness," of course, is a relative term.

Flip Side?

With C corporations, one must worry about unreasonably *high* compensation that may not be deductible by the payer C corporation. In the S corporation context, the question is when compensation is unreasonably *low*. If it is, then some or all of the dividends or other distributions paid to S corporation owner(s) can be recharacterized and treated as compensation subject to payroll taxes.

There has been recently renewed debate about precisely this point, and as we'll see, the clumsily named American Jobs and Closing Tax Loopholes Act of 2010 has something to add. Yet this issue has had a storied history for at least the last 20 years.

Of course, the majority of cases have involved extreme fact patterns. For example, recharacterization should be no surprise if a single incorporated professional pays himself no compensation whatsoever and insists that all of the money paid through his personal efforts to his corporation is "dividends." [For early cases on this topic, *see J. Radtke,*

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DC-WI, 89-2 USTC ¶9466, 712 FSupp 143 (1989), *aff'd*, CA-7, 90-1 USTC ¶50,113, 895 F2d 1196 (1990); *Spicer Accounting Corp.*, CA-9, 91-1 USTC ¶50,103, 918 F2d 90 (1990).]

But what amount of compensation is unreasonably low? Does it depend on what other payments there are and in what amounts? Those are inherently factual issues, which after all is what the flip side of the reasonable compensation debate is also normally about. Section 413 of the recently passed Unemployment Compensation Extension Act of 2010 (also known as the American Jobs and Closing Tax Loopholes Act of 2010), H.R. 4213, P.L. 111-205, contains a provision that is decidedly not Solomonic in approach. Just tax it all, the law says.

The new law does this by clamping down on the owners of certain S corporations. Here's how it works: Shareholders who provide services to "Disqualified S Corporations" will now face self-employment tax on the distributions they receive from the corporation, even if those payments are characterized as dividends or profits. Since the self-employment tax embodies both the employer's and employee's share of employment tax, it is essentially wage treatment.

New Law = Wide Net

The provision applies to tax years beginning after 2010, and cuts a wide swath through closely held companies *via* a broad definition of Disqualified S Corporations. Disqualified S corporations include:

- any S corporation that is a partner in a professional service partnership, where the services are substantially all of the activities of the corporation; and
- any S corporation engaged in professional services if the principal asset is the reputation and skill of three or fewer employees.

Professional service businesses are those where substantially all of their activities involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management and brokerage services. Gee, considering that "consulting" is among the culprits named, have they left anything out?

As if this weren't enough, there's also family attribution. Even if family members don't provide any services to the corporation, if they receive dividend or profit distributions from the S corporation, there's more tax to pay. In such a case, the service provider gets thwacked with self-employment tax on all of the monies paid to the family members.

Dr. Watson, I Presume?

In addition to this new legislation, there's a recent District Court case worthy of note. In *Watson v. U.S.*, 2010 U.S. Dist. LEXIS 52407 (S.D. Iowa 2010), Mr. Watson and three others formed an accounting firm. A few years later, Watson incorporated his own professional corporation, as did his partners. By late 1996, the accounting firm had four professional corporation partners. Watson continued providing accounting services full time, but only received $24,000 in salary from the firm in each of 2002 and 2003. However, the dividends Watson received were rich.

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In 2002 alone, in addition to his $24,000 in salary, Watson received $203,651 in dividends. In 2003, in addition to his $24,000 salary, Watson received $221,577 in dividends. In both years, Watson worked full time for the accounting firm, and his monthly living expenses (the court pointed out) exceeded his $2,000 monthly salary.

The IRS assessed additional payroll taxes, claiming that the dividends Watson received had to be recharacterized as wages. The District Court agreed, noting that the IRS was not bound by a self-proclaimed $24,000 salary payment. The IRS was entitled to recharacterize dividends, said the court.

The fact that the firm properly documented the salary and dividend payments on its corporate records did not bind the tax result. The corporation asserted that the IRS could not compel the corporation to pay a higher salary to the owner. The District Court disagreed.

The analysis, said the court, was whether the payments were made as remuneration for services performed. That is straightforward, but it is also primarily factual. The court ordered the case to proceed to determine whether the dividends here were really remuneration for services performed or were something else.

IRS Fact Sheet 2008-25 (August 2008) warns S corporations not to attempt to avoid paying employment taxes by payments to officers/shareholders as cash distributions, payments of personal expenses, and/or loans. The instructions to Form 1120S also state clearly that distributions and other payments the S corporation makes to an officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered.

Don't Forget History

Apart from *Radtke* and *Spicer Accounting*, there are other cases too. In *J.M. Joly*, CA-6, 2000-1 USTC ¶50,315, 211 F3d 1269 (2000), the Sixth Circuit ruled that an S corporation's distributions to its controlling shareholders were wages. The court even ignored the express written agreement that any excess amounts would be treated as loans to the shareholder.

The Tax Court has decided many similar cases. *See J.M. Grey*, 119 TC 121, Dec. 54,871 (2002), *aff'd*, CA-3, 2004-1 ¶50,214, 93 FedAppx 473 (2004), *cert denied*, 543 US 821 (2004). *See also Greenlee Inc.*, DC-CO, 87-1 USTC ¶9306, 661 FSupp 642 (1985); *Olde Raleigh Realty Corp.*, TC Summary Opinion 2002-61 (2002).

There will be more to come on this issue, particularly in light of new legislation.