S Corporations

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Reasonable Compensation: Dividends vs. Wages—A Reverse in Positions

For many years, taxpayers and the Internal Revenue Service have battled over what constitutes reasonable compensation for shareholder-employees of C corporations. On one side, taxpayers have argued for high levels of compensation that are deductible by the corporation. On the other side, the Service has sought to recharacterize excessive wages paid to shareholder-employees as nondeductible dividend distributions.[1]

Recently, however, the increasing popularity of S corporations[2] and the increase in Social Security taxes[3] have combined to cause a role reversal in the reasonable compensation area. To avoid Social Security taxes, many shareholder-employees of S corporations are decreasing the amount of wages that they receive and simultaneously increasing the amount of S corporation distributions made to them. In response to this strategy, the Service is seeking to recharacterize S corporation distributions as wages in certain "abusive" situations.[4]

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[1] The primary argument used by the Service in recharacterizing compensation as dividends is that such compensation is unreasonable under § 162(a)(1), Reg. § 1.162-7(a), and the progeny of case law thereunder.

[2] S corporations have become more popular in recent years due to legislative changes made by TRA '86 (Pub. L. No. 99-514, 100 Stat. 2085), which include the repeal of the *General Utilities* doctrine, the reduction of individual tax rates below corporate tax rates, and the broadening of the scope of the corporate alternative minimum tax, which does not apply to S corporations.

[3] See text accompanying notes 5–15 *infra*.

[4] The Service is apparently modifying its computerized audit programs to select automatically S corporation returns that show ordinary income and distributions to shareholders, but that show no compensation paid to the officers of the corporation. Additionally, at least two service centers (Kansas City and Austin) are sending S corporation shareholders deficiency notices that recharacterize nontaxable distributions as wages subject to Social Security taxes where the S corporation return shows distributions to shareholders but no compensation paid to such shareholders. The deficiency notices sent by these service centers also include penalties for failure to file under § 6651 and for failure to deposit payroll taxes under § 6656. See Clements & Streer, "How Low Can Owner-Employee Compensation Be Set to Save on Employment Taxes?" 2 J. S Corp. Tax'n 37 (1990); Andrews, "Current Non-Stock Executive Compensation and Fringe Benefit Issues," 1 S Corp.: J. Tax, Leg. & Bus. Strategies 3 (1989); Spradling, "Are S Corp. Distributions Wages Subject to Withholding?" 71 J. Tax'n 104 (1989).

S Corporation Distributions and Social Security Taxes

In order for shareholder-employess of S corporations to realize employment tax savings by withdrawing funds in the form of distributions, rather than compensation, such distributions must not be recharacterized as "wages" for FICA and FUTA purposes[5] or as "net earnings from self-employment" for purposes of the tax on self-employment income.[6] At first glance, it might appear that a shareholder's distributive share of income from an S corporation constitutes net earnings from self-employment since a general partner's distributive share of the income of any trade or business carried on by a partnership of which he is a member generally constitutes net earnings from self-employment subject to the tax on self-employment income.[7] Nevertheless, dividends on shares of stock issued by a corporation are specifically excluded from the definition of net earnings from self-employment.[8]

Additionally, in Revenue Ruling 59-221,[9] the Service found that an

[5] For FICA and FUTA purposes, §§ 3121(a) and 3306(b), respectively, define the term "wages" to mean all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions. See text accompanying notes 49–57 *infra* for a discussion concerning the recharacterization of S corporation distributions as wages for FICA and FUTA purposes.

[6] Sections 1401(a) and 1401(b) impose an aggregate tax of 15.3 percent on the self-employment income of every individual. Under § 1402(b), self-employment income is defined as the net earnings from self-employment derived by an individual during any taxable year to the extent that such individual's net earnings from self-employment are greater than $400 and not in excess of the maximum wage limit prescribed under Social Security Act § 230, 42 U.S.C. § 430 (1988 and Supp. 1990). For 1990, the maximum wage limit is $51,300. Effective for taxable years beginning after 1989, § 164(f) permits individuals to take an income tax deduction equal to one half of the taxes imposed under § 1401.

[7] Section 1402(a) expressly provides that net earnings from self-employment include an individual's distributive share (whether or not distributed) of income or loss under § 702(a)(8) from any trade or business carried on by a partnership of which he is a member, subject to certain specified exceptions set forth in §§ 1402(a)(1)–1402(a)(15). For example, § 1402(a)(13) generally provides that a limited partner's distributive share of any item of income or loss from a limited partnership does not constitute net earnings from self-employment within the meaning of § 1402(a).

[8] See I.R.C. § 1402(a)(2).

[9] 1959-1 C.B. 225. See also Rev. Rul. 66-327, 1966-2 C.B. 357, where the Service found that the taxable income of an S corporation included in its shareholders' gross income is not income derived from a trade or business for purposes of computing the shareholders' net operating losses (NOLs) under § 172(c); LTR 8716060, where the Service concluded that the income derived by a shareholder-employee from an S corporation did not constitute net earnings from self-employment for self-employment tax purposes and that such taxpayer was not eligible to adopt a qualified pension plan based on the income derived from his S corporation since such income did not constitute earned income. See generally Clements & Streer, note 4 *supra*, at 41; Andrews, note 4 *supra*, at 4; Spradling, note 4 *supra*, at 105.

S corporation's income does not constitute net earnings from self-employment for purposes of the tax on self-employment income. Consequently, neither a shareholder's distributive share of income passed through from the S corporation under Section 1366 nor any S corporation distributions actually received by the shareholder from the S corporation constitute net earnings from self-employment subject to the tax on self-employment income.

Because wages paid to shareholder-employees of S corporations are subject to Social Security taxes while S corporation distributions are not, shareholder-employees have an opportunity for significant tax savings by withdrawing funds from the S corporation in the form of distributions, rather than wages. For 1990, a tax of 7.65 percent[10] of the wages paid to an employee (not to exceed $51,300 of wages per employee)[11] is imposed on both the employer and the employee for FICA taxes, resulting in a potential maximum tax of $7,849 per employee. Additionally, for 1990, a tax of 6.2 percent[12] of the wages paid to an employee (not to exceed $7,000 of wages per employee)[13] is imposed on the employer for FUTA taxes, resulting in a potential maximum tax of $434 per employee.

With a total potential employment tax savings of $8,283 per employee ($7,849 FICA plus $434 FUTA),[14] it is not difficult to understand why many shareholder-employees of S corporations wish to achieve tax savings by decreasing the amount of wages paid to them and correspondingly increasing the amount of S corporation distributions.[15] Prior to advising an S corporation with shareholder-employees to undertake such a tax planning strategy, however, a tax practitioner should analyze the economic and tax consequences that such a strategy will have on the S corporation and its shareholders as well as whether the Service will attempt to recharacterize the increased distributions as wages.

[10] I.R.C. §§ 3101(a), 3101(b), 3111(a), 3111(b).

[11] I.R.C. § 3121(a)(1); Social Security Act § 230.

[12] I.R.C. § 3301(1).

[13] I.R.C. § 3306(b)(1).

[14] Besides potential FICA and FUTA tax savings, there may be additional state tax savings where the state imposes unemployment taxes in addition to the federal unemployment tax. Nevertheless, to the extent that a shareholder-employee is receiving wages that are subject to FICA and FUTA taxes from sources other than the S corporation, the potential maximum tax savings with respect to such shareholder-employee may be less than $8,283.

[15] Where a sole proprietorship or partnership incorporates as an S corporation, the shareholder-employees of the newly formed S corporation can realize employment tax savings if (1) the salary that they receive from the S corporation is less than 86 percent of the preconversion self-employment business income, minus $2,837, and (2) the salary received by the shareholder-employee is less than $41,281. The amount of employment tax savings in such situations can be computed by using the following formula where I equals the preconversion self-employment income subject to self-employment tax and S equals the salary paid to the shareholder-employee after the conversion to S corporation status: Employment tax savings = $0.13158(I) - 0.153(S) - \$434$. See Clements & Streer, note 4 *supra*, at 38, 39.

Economic Impact on Shareholders

Although the amount of funds available for distribution to an S corporation's shareholder-employees will increase as the wages paid to them decrease, all distributions made by the S corporation to its shareholders must be made in proportion to the number of shares held by such shareholders, whether employees or not.[16] Thus, if an S corporation with both shareholder-employees and shareholder-nonemployees adopts a tax strategy to reduce Social Security taxes by minimizing wages and maximizing distributions, the increase in the amount of distributions made to the shareholder-employees will be less than the amount by which their wages were reduced. Accordingly, a tax practitioner should analyze the economic effect of this strategy on the shareholder-employees of an S corporation prior to adopting such a program.[17]

Tax Impact of S Corporation Distribution Rules

In general, the taxability of a distribution by an S corporation to its shareholders is a function of three factors: (1) any accumulated earnings and profits of the S corporation, (2) the S corporation's accumulated adjustments account, and (3) the shareholders' basis in their stock.[18] A distribution by an S corporation that has no accumulated earnings and profits (E&P) (E&P accumulated while the corporation was a C corporation) will be tax-free to the extent that the distribution does not exceed the adjusted basis of a shareholder's stock and will constitute capital gains to the extent that the distribution exceeds the adjusted basis of such shareholder's stock.[19] Consequently, S corporations with no accumulated E&P generally can achieve current income tax savings as well as employment tax savings by causing amounts that would otherwise be withdrawn as wages to be withdrawn as S corporation distributions.

A five-tier system of taxation exists for distributions made by S corporations having accumulated

[16] Non-pro-rata distributions to shareholders would violate the second class of stock requirement under § 1361(b)(1)(D).

[17] A tax practitioner should also consider certain other nontax considerations. For example, a program that minimizes the amount of wages paid to shareholder-employees will increase (1) purchase price formulas based on earnings and (2) bonus formulas for employees who are not shareholders of the S corporation that are based on earnings.

[18] I.R.C. § 1368.

[19] I.R.C. §§ 1368(b)(1), 1368(b)(2). Because a shareholder's basis in his S corporation stock is reduced under § 1367(a)(2)(A) by the amount of distributions from the S corporation that are not includable in the shareholder's income, the current income tax saving realized by shareholder-employees as a result of the tax-free distributions is merely a tax-deferral, rather than a tax-avoidance, mechanism, assuming that capital gains continue to be taxed at the same rate as ordinary income.

E&P.[20] This system of taxation uses a concept known as the "accumulated adjustments account," which consists of the accumulated gross income of the S corporation, less deductible expenses and prior distributions of the S corporation.[21]

The five-tier system may be summarized as follows:

1. That portion of the distribution that does not exceed the shareholder's pro rata portion of the accumulated adjustments account is tax-free to the extent of the shareholder's basis in his stock.
2. That portion of the distribution that does not exceed the shareholder's pro rata portion of the accumulated adjustments account but that does exceed the shareholder's basis in his stock is capital gains.
3. That portion of the distribution that exceeds the shareholder's pro rata portion of the accumulated adjustments account is a dividend to the extent of the S corporation's accumulated E&P.
4. That portion of the distribution that exceeds the shareholder's pro rata portion of the accumulated adjustments account and the accumulated E&P of the S corporation is tax-free to the extent of the shareholder's residual basis in his S corporation stock (the shareholder's adjusted basis in his S corporation stock, less any reductions made in the shareholder's basis for any first-tier distributions).
5. That portion of the distribution that exceeds the shareholder's pro rata portion of the accumulated adjustments account, the accumulated E&P of the S corporation, and the shareholder's residual basis in his stock is capital gains.[22]

Because of the potential adverse income tax consequences to shareholders under the S corporation distribution rules discussed above (especially where the S corporation has accumulated E&P), tax practitioners should determine the tax effect of such distributions on S corporation shareholders prior to recommending that an S corporation embark on a tax strategy to reduce employment taxes by decreasing wages and increasing distributions.

[20] I.R.C. § 1368(c).

[21] I.R.C. § 1368(e)(1). In general, the accumulated adjustments account is computed in the same manner as adjustments are made to a taxpayer's basis in his S corporation stock under § 1367. In determining the accumulated adjustments account of an S corporation, however, no adjustment is made for tax-exempt income (and related expenses), no adjustment is made for federal taxes attributable to any taxable year during which the corporation was a C corporation, and the accumulated adjustments account may be reduced below zero for distributions made by the S corporation that are not includable in the income of the S corporation's shareholders. See § 1368(e)(1)(A). Essentially, the accumulated adjustments account of an S corporation is a running total of the income, losses, and distributions made by the S corporation during the most recent continuous period during which the corporation has been an S corporation. See I.R.C. § 1368(e)(2).

[22] I.R.C. §§ 1368(c), 1368(b). See Lai, "Compensating S Corporation Officers," 67 Taxes 185 (1989), for a discussion of the interplay between salary levels and the distribution rules of § 1368. For an excellent discussion of the § 1368 distribution rules, see Ginsburgh, "Distributions," 1 S Corp.: J. Tax, Leg. & Bus. Strategies 57 (1989).

Built-in Gains Tax

In addition to the distribution rules under Section 1368, a tax strategy to minimize the amount of wages paid to shareholder-employees of an S corporation may also affect a corporation's built-in gains tax liability under Section 1374. Section 1374 imposes a corporate-level tax on the built-in gains of S corporations that were previously C corporations[23] and applies to built-in gains recognized during the ten-year period following such corporation's conversion to S status.[24] The built-in gains tax is presently 34 percent (the highest rate of tax set forth in Section 11(b)) of the "net recognized built-in gain" of the S corporation for its taxable year.[25]

The net recognized built-in gain of an S corporation is the lesser of (1) the amount that would be the taxable income of the S corporation for the taxable year if only recognized built-in gains and recognized built-in losses were taken into account or (2) such corporation's taxable income for the taxable year computed without the benefit of the dividends-received deduction or the deduction for NOL carryovers.[26] Since the base of the built-in gains tax is the lesser of the taxable income of the corporation or the amount that would be its taxable income if only recognized built-in gains and recognized built-in losses were taken into account, *a corporation may minimize or eliminate the built-in gains tax for a given taxable year by reducing or eliminating its taxable income.* Nevertheless, for corporations making S elections after March 31, 1988, to the extent that the taxable income of the corpo-

[23] I.R.C. § 1374(a). The purpose behind the enactment of the built-in gains tax by TRA '86 was to prevent the circumvention of the repeal of the *General Utilities* doctrine by electing to be an S corporation. Under § 1374(c)(1), only S corporations that were previously C corporations are subject to the built-in gains tax. Additionally, however, § 1374(d)(8) subjects S corporations with no prior C history to the built-in gains tax with respect to assets acquired from C corporations in certain tax-free asset acquisitions.

[24] I.R.C. § 1374(d)(7). In the case of an S corporation's acquisition of assets subject to the built-in gains tax under § 1374(d)(8), the ten-year recognition period begins on the day that such assets are acquired from the C corporation, rather than on the first day of the corporation's first taxable year as an S corporation.

[25] I.R.C. § 1374(b)(1). Section 1374(b)(4) provides that where the gain is attributable to the disposition of an asset that would produce long-term capital gains, the rate of tax may not exceed the rate that would be imposed under § 1201(a). For corporations subject to the built-in gains tax, § 1366(f)(2) provides for the reduction of the amount of gain that would otherwise pass through to the corporation's shareholders under § 1366 by the amount of the built-in gains tax.

[26] I.R.C. § 1374(d)(2).

ration is less than the excess of the corporation's recognized built-in gains over its recognized built-in losses, such excess will be carried forward and treated as built-in gains in the corporation's succeeding taxable year.[27] If the corporation can eliminate (or greatly reduce) its taxable income during the entire ten-year recognition period, however, the corporation may be able to avoid completely imposition of the built-in gains tax.

One method of minimizing an S corporation's taxable income is for the S corporation to pay high levels of compensation to its shareholder-employees.[28] Thus, in many cases, it may be more advantageous from a tax perspective for an S corporation subject to the built-in gains tax to maximize salaries paid to its shareholder-employees to reduce its taxable income, rather than to minimize the salaries paid to them in order to reduce employment taxes. Accordingly, prior to recommending that an S corporation adopt a tax strategy of minimizing salaries to reduce employment taxes, a tax practitioner should analyze the effect of such a strategy on the S corporation's potential built-in gains tax liability. In any event, tax practitioners should be prepared to support the reasonableness of the amount of compensation paid to shareholder-employees of S corporations, whether the compensation paid is set at a high level to reduce the S corporation's built-in gains tax liability or at a low level to minimize Social Security taxes.[29]

Recharacterization of S Corporation Distributions as Wages

☐ **Reasonable Compensation in the C Corporation Context.** In determining whether S corporation distributions may be subject to recharacterization as wages based on reasonable compensation standards, the courts may look to the principles developed in the C corporation area where taxpayers have traditionally argued for high levels of deductible compensation and the Service has sought to recharacterize excessive compensation as nondeductible dividend distributions.

The relevant authority in this area is Section 162(a)(1), which allows a deduction for ordinary and necessary expenses paid or incurred during a taxable year in carrying on a trade or business, including a "reasonable allowance" for salaries or other compensation for personal services actually rendered. The regulations under Section 162(a)(1) provide that the test of deductibility in the case of compensation payments is whether such payments are reasonable and are, in fact, payments purely for services.[30] Consequently, there is a two-prong test for the deductibility of compensation payments: (1) whether the amount of the payment is *reasonable* in relation to the services performed and (2) whether the payment was, in fact, *intended* to be compensation for services rendered.

In determining whether the payment was intended to be compensation for services rendered, the courts have relied heavily on the initial characterization of the payment by the corporation and have focused on such objective criteria as whether the board of directors authorized the payment of the compensation in question, whether employment taxes were withheld from the payment, whether a Form W-2 was issued with regard to the payment in question, and whether the payment was deducted on the accounting records or tax returns of the corporation as salary.[31] Similarly, in an S corporation context courts have generally not allowed taxpayers to retroactively recharacterize dividend distributions as wages[32]; however, courts have allowed the Service to do so in limited circumstances.[33]

In determining whether compensation payable to a particular employee is reasonable, the Service and the courts have focused on a number of objective criteria.[34] The

[27] I.R.C. § 1374(d)(2)(B), *as enacted by* TAMRA § 1006(f), Pub. L. No. 100-647, 102 Stat. 3342 (1988).

[28] For a discussion of ways to minimize built-in gains tax, see Comiter & Looney, "Minimizing the Built-in Gains Tax Imposed Under Section 1374," 7 J. Partnership Tax'n 171 (1990).

[29] Although the Service has not traditionally asserted "reasonable compensation" arguments with respect to S corporations, the reduction of an S corporation's taxable income for purposes of minimizing the built-in gains tax by means of the payment of excessive compensation could prompt the Service to use reasonable compensation arguments in this context. For a discussion of the reasonable compensation arguments traditionally asserted by the Service in the C corporation context, see text accompanying notes 30–36 *infra*.

[30] Reg. § 1.162-7(a).

[31] See, e.g., Paula Constr. Co. v. Comm'r, 58 T.C. 1055 (1972), *aff'd per curiam*, 474 F.2d 1345 (5th Cir. 1973); Electric & Neon, Inc. v. Comm'r, 56 T.C. 1324 (1971), *aff'd per curiam*, 496 F.2d 876 (5th Cir. 1974).

[32] See text accompanying notes 43–48 *infra*.

[33] See text accompanying notes 37–42 and 49–57 *infra*.

[34] The leading case in this area is Mayson Mfg. Co. v. Comm'r, 178 F.2d 115 (6th Cir. 1949), which sets forth nine factors to be used in evaluating the reasonableness of the amount of an employee's compensation. These nine factors are (1) the employee's qualifications; (2) the nature, extent, and scope of the employee's work; (3) the size and complexities of the business; (4) a comparison of the salaries paid with the gross income and the net income of the business; (5) the prevailing general economic conditions; (6) a comparison of salaries with distributions to stockholders; (7) the prevailing rates of compensation for comparable positions in comparable businesses; (8) the salary policy of the taxpayer for all employees; and (9) the compensation paid to the particular employee in prior years where the business is a closely held corporation. For factors used by other courts, see generally Elliotts, Inc. v. Comm'r, 716 F.2d 1241, 1245–1248 (9th Cir. 1983); Kennedy v. Comm'r, 671 F.2d 167, 173, 174 (6th Cir. 1982); Trucks, Inc. v. United States, 588 F. Supp. 638, 642, 643 (D. Neb. 1984); Diverse Indus., Inc. v. Comm'r, T.C. Memo. 1986-84; Foos v. Comm'r, T.C. Memo. 1981-61. For an excellent discussion of reasonable compensation issues in the C corporation area, see Kafka & Hoenicke, "Reasonable Compensation," 390 Tax Mgmt. (BNA)—1987); Clements & Streer, note 4 *supra*, at 49, 50.

factors cited by the courts generally can be grouped into three categories: (1) the actual value of the taxpayer's performance, (2) the amount of salary paid to employees in other corporations in similar positions as the taxpayer, and (3) the financial and economic condition of the employer-corporation.[35]

Although there is extensive authority under Section 162(a)(1) for determining what constitutes reasonable compensation, the intent of Section 162(a)(1) is apparently to bring salary payments down to a reasonable level in order to limit excessive payments of deductible salaries to shareholder-employees of C corporations.[36] Consequently, it is not entirely clear whether such authority can be utilized by the Service to bring salary payments *up* to a level properly reflecting adequate compensation for services performed.

☐ **Recharacterization of S Corporation Distributions as Wages by the Service Under Section 1366(e).** The Service is expressly authorized under Section 1366(e) to recharacterize S corporation distributions as wages of a particular shareholder where such shareholder is a member of the family of one or more of the other shareholders and has rendered services for the corporation without receiving reasonable compensation for such services.[37] Since the focus of the Service under both Section 1366(e) and the employment tax area is to ensure that salaries are set at a sufficiently *high* level, the principles developed under Section 1366(e) may be indicative of the type of criteria courts will use to recharacterize S corporation distributions as wages in the employment tax area.

In *Roob v. Comm'r*,[38] the court applied the predecessor of Section 1366(e) to increase the salary of one of the shareholders of a family-owned corporation to reflect the additional value of his services to the corporation. In reaching its decision, the court held that the criteria used in determining reasonable compensation under Section 162 (a)(1) applied with equal force to the Section 1366(e) area.[39]

In *Krahenbuhl*,[40] the Service was again successful in utilizing the predecessor of Section 1366(e) to recharacterize distributions made to shareholders of a family-owned corporation as wages of one of the

[35] See Trucks, Inc., 588 F. Supp. at 638, 642, 643.

[36] See, e.g., Krahenbuhl v. Comm'r, T.C. Memo. 1968-34.

[37] Section 1366(e) specifically provides that if an individual who is a member of the family (within the meaning of § 704(e)(3)) of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without receiving reasonable compensation, the Service will make such adjustments in the items taken into account by such individual and such shareholders as may be necessary to reflect the value of such services or capital.

[38] 50 T.C. 891 (1968). The *Roob* decision involved the predecessor of § 1366(e), § 1375(c), which is essentially identical to § 1366(e).

[39] The court in *Roob* (50 T.C. at 891) specifically cited *Mayson Manufacturing* (178 F.2d at 115) for the criteria set forth in that case.

[40] T.C. Memo. 1968-34.

S corporation's shareholders. In its decision, however, the court stated that the task of the Service in protecting revenue under Section 1366(e) required a different emphasis from the responsibility that the Service has under Section 162(a)(1) for determining a reasonable allowance for salaries or compensation for services. Specifically, the court found that the emphasis under Section 1366(e) is to bring salaries *up* to a reasonable amount whereas the emphasis under Section 162(a)(1) is on bringing salaries *down* to a reasonable amount.

Nevertheless, in several other cases in which the Service was unsuccessful in recharacterizing S corporation distributions to shareholder-employees as wages under Section 1366(e), courts have relied on the criteria and authorities established under Section 162(a)(1) to hold that the wages paid to shareholder-employees were not unreasonably *low*.[41] In each of these cases, the shareholder-employees performed very few services on behalf of the corporation and devoted little time to the corporation's activities.

Since courts have used the criteria established under Section 162(a)(1) to determine whether wages paid to shareholder-employees are unreasonably *low* (as opposed to unreasonably *high* in a Section 1366(e) context, courts may be willing to apply the Section 162(a)(1) line of authority in the employment tax context to determine whether wages paid to shareholder-employees are set at unreasonably low levels.

The cases discussed above also indicate that the courts are unwilling to recharacterize S corporation distributions as wages under Section 1366(e) where a shareholder-employee performs few services on behalf of the S corporation and devotes little time to the S corporation's activities.[42] Accordingly, a tax strategy to reduce employment taxes by minimizing wages and maximizing distributions may not be subject to attack by the Service where the shareholder-employees of the S corporation do not perform substantial services on behalf of the S corporation. Substantial employment tax savings could be achieved by paying minimal salaries to (1) shareholder-employees of S corporations that are involved in passive investments or (2) shareholder-employees who are passive investors in S corporations conducting active businesses.

☐ **Recharacterization of Distributions as Wages by Taxpayers.** There have been a number of cases involving S corporations in which shareholder-employees, rather than the Service, have attempted to recharacterize corporate distributions as wages.[43] In *Bramlette Building*

[41] See Trucks, Inc., 588 F. Supp. at 638, 642, 643; Davis v. Comm'r, 64 T.C. 1034 (1975); Rocco v. Comm'r, 57 T.C. 826 (1972).

[42] See note 41, *supra*.

[43] Taxpayers have argued for the recharacterization of distributions as wages in the S corporation context where (1) the corporation's S election has been terminated and (2) the distributions would be subject to the 50 percent maximum tax on earned income.

Corp. v. Comm'r,[44] an S corporation that had its S status terminated because of excessive passive investment income attempted to recharacterize amounts distributed to one of its shareholder-employees (the president) as wages so that such amounts would be deductible by the corporation. The court held that such amounts could not be recharacterized as wages since there was no objective evidence that the payments to the shareholder-employee were ever intended to be anything other than dividend distributions. The court in *Bramlette* did not reach the issue of whether the amount of wages paid to the shareholder-employee was reasonable under Section 162(a)(1).

Similar facts were presented to the Tax Court in *Paula Construction Co.*,[45] where the court again held that a corporation (that had its S status terminated) was not entitled to recharacterize distributions made to its shareholder-employees as deductible wages. In its decision, the Tax Court stated that only payments made with the intent to compensate may be deductible as compensation, and whether such intent has been demonstrated is a factual question to be decided based on the particular facts and circumstances of the case. The corporation in *Paula Construction Co.* failed to demonstrate such intent since there was no corporate authorization for the payment of salaries, the disbursements were not reflected as payments of compensation in the books and records of the corporation, no sums were reported on Forms W-2, and there were no deductions for salaries claimed either on the corporation's federal or state tax returns. Although the Tax Court determined that the shareholder-employees in question could have been paid additional deductible compensation as a result of their performing substantial services for the corporation, the court decided the case based on what was actually done, and as such, the treatment of the payments could not be changed retroactively.

In two other cases involving S corporations, *Gurentz v. Comm'r*[46] and *Migliore v. Comm'r*,[47] taxpayers attempted to reclassify distributions from S corporations as wages in order to subject such amounts to the maximum tax limitation on earned income. In each of these cases, the Tax Court held that the shareholder-employees could not recharacterize distributions received by them as wages since they failed to show that the distributions were paid to them in lieu of reasonable compensation. Neither case specifically cited Section 162(a)(1) or any of the case law precedent decided thereunder.

These cases indicate that, in an S corporation context, courts will not be receptive to taxpayers who attempt to retroactively recharacterize distributions as wages (even where such taxpayers have performed substantial services for the corporation)[48] in the absence of objective evidence clearly indicating that the payment in question was actually intended to be compensation for services rendered. Moreover, unless such intent is evidenced, the issue of whether the amount of compensation is reasonable may not even be addressed by the court. By analogy, courts should not be receptive to similar arguments made by the Service in an employment tax context. Additionally, taxpayers should be able to utilize this authority to rebut arguments by the Service to retroactively recharacterize S corporation distributions as wages.

☐ **Recharacterization of S Corporation Distributions as Wages in Abusive Situations.** The Service is, however, actively pursuing recharacterization of S corporation distributions as wages subject to social security taxes in certain abusive situations.[49] The primary authority cited by the Service in favor of such recharacterization is Revenue Ruling 74-44.[50]

In Revenue Ruling 74-44, two shareholders of an S corporation drew no salary from the corporation and arranged for the corporation to pay them dividends equal to the amount that they would have otherwise received as reasonable compensation for services performed. This arrangement was made for the express purpose of avoiding payment of federal employment taxes. Based on the expansive definition of wages for FICA and FUTA purposes (which includes all remuneration for employment), the Service found that the dividends paid to the shareholders constituted wages for FICA and FUTA purposes.

Revenue Ruling 74-44 did not, however, address the issue of what constitutes reasonable compensation in the S corporation context since the ruling expressly stated that the dividends were received by the shareholder-employees in lieu of the reasonable compensation that would have otherwise been paid to them. Despite this shortcoming, Revenue Ruling 74-44 clearly indicates that the payment of *no* compensation will be unreasonable where shareholder-employees provide substantial services to the corporation.[51]

The one case that has directly addressed the recharacterization of

[44] 52 T.C. 200 (1969), *aff'd*, 424 F.2d 751 (5th Cir. 1970).

[45] 58 T.C. at 1055, *aff'd per curiam*, 474 F.2d at 1345.

[46] T.C. Memo. 1978-238.

[47] T.C. Memo. 1977-247.

[48] See Paula Constr. Co., 58 T.C. at 1055, *aff'd per curiam*, 474 F.2d at 1345, and text accompanying note 45 *supra*.

[49] See note 4 *supra* and accompanying text.

[50] 1974-1 C.B. 287. For a discussion of the facts underlying Rev. Rul. 74-44, see Andrews, note 4 *supra*, at 4, 5; Spradling, note 4 *supra*, at 105.

[51] See also Rev. Rul. 71-86, 1971-1 C.B. 285 (president and sole shareholder of closely held corporation found to be an "employee" of the corporation for employment tax purposes); Rev. Rul. 73-361, 1973-2 C.B. 331 (officer-shareholder of an S corporation who performed substantial services as an officer of the S corporation is an "employee" of the corporation for purposes of FICA, FUTA, and income tax withholding); and LTR 7949022 (shareholder-employees of S corporation who performed substantial services for S corporation treated as "employees" for employment tax purposes).

S corporation distributions as wages in the employment tax context also involved an abusive situation. In *Radtke v. Comm'r*,[52] the taxpayer, the sole shareholder of a law firm, made all of his withdrawals from the S corporation in the form of S corporation distributions and received *no* salary from the S corporation during the taxable year. The court disagreed with the taxpayer's argument that dividends cannot constitute wages for FICA and FUTA purposes and held that the payments in question functioned as remuneration for services performed and thus constituted wages for FICA and FUTA purposes. Accordingly, it appears that courts will be receptive to the Service's attempts to recharacterize dividends as wages in particularly abusive situations, such as those present in *Radtke* and Revenue Ruling 74-44.

In nonabusive situations, however, the Service may have difficulty in successfully asserting that distributions made by S corporations to shareholder-employees should be recharacterized as wages subject to Social Security taxes. In this regard, the Service would have to overcome the following "obstacles":

1. The lack of express authority for its position (unlike the express authority granted to the Service under Section 1366(e) to recharacterize dividend distributions as wages[53];
2. The reluctance of the courts to recharacterize distributions as wages[54]; and
3. The uncertainty surrounding the utilization of Section 162(a)(1) by the Service in the employment tax context to bring salaries down to a reasonable level.[55]

Thus, in situations involving shareholder-employees of S corporations who perform minimal services, a tax strategy of decreasing wages and increasing distributions should result in substantial employment tax savings since the increased distributions should not be subject to recharacterization.[56] Nevertheless, due to the lack of authority in this area, it is unclear what *standards* a court will apply in an employment tax context to determine whether and to what extent amounts received as distributions by shareholder-employees who perform *significant* services should be recharacterized as reasonable compensation for services.

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[52] 712 F. Supp. 143 (E. D. Wis. 1989), *aff'd*, 90-1 U.S.T.C. ¶ 50, 113, 65 A.F.T.R.2d 90-1155 (7th Cir. 1990).

[53] See text accompanying notes 37–42 *supra.*

[54] See text accompanying notes 43–48 *supra.*

[55] See note 36 *supra* and accompanying text.

[56] See text accompanying notes 16–17 *supra* for a discussion of the potential problems for an S corporation that has both shareholder-employees and shareholder-nonemployees.

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