Unreasonably Low S Corporation Pay

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S corporation compensation continues to cause confusion and generate legislation. The authors examine the role of payroll taxes in the S corporation context and the porous dividing line between dividend payments and compensation when passthrough entities are involved.

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In an age of acronyms, it is hard not to like the NEWT Act, the Narrowing Exceptions for Withholding Taxes Act of 2012 (H.R. 3840). Yet in some ways it is more aptly named after former House Speaker Newt Gingrich. As his presidential campaign fizzled out, Gingrich faced scrutiny over how much pay he takes from S corporations and the payroll taxes he avoids by having the S corporations make profit or dividend distributions. As discussed below, the S corporation payroll issue is also raised in the Stop Student Loan Interest Rate Hike Act of 2012 (S. 2343).

Gingrich is unlikely to be the last person or even the last politician asked about these issues. There has been a recurring if not persistent discussion of this tax matter over the last 20 years. It may finally be coming to a head, again. We are talking, of course, about payroll taxes and what is in many respects the flip side of the reasonable compensation coin.

Pundits suggest that Gingrich should not have avoided thousands of dollars of Medicare payroll taxes in 2010. How did he do it? He ensured that the lion's share of monies emanating from his two S corporations came via dividend distributions, not in the form of salary or bonus.

In most respects, that seems unexceptional. But in an age when politicians and even some others trumpet their tax rates like membership badges, these issues have taken on a strange hue. How legitimate or questionable you find Gingrich's actions depends on your perspective.

Yet it also depends largely on the facts and precisely who did what, when, and to what effect. After all, in any reasonable compensation case, whether one is asking what is unreasonably high or low pay, much depends on overall reasonableness. Inherently, that is not a bright line.

Medicare taxes are levied at a rate of 2.9 percent on an unlimited amount of compensation and self-employment income. Self-employment income includes services rendered as a proprietor, consultation under a consulting contract, and fees for speeches or book royalties.[1] It seems hard to argue otherwise.

But, key to Gingrich, self-employment income does not include profits from a business. He treated $444,327 of the payments from his two S corporations, Gingrich Holdings Inc. and Gingrich Productions, as compensation. That left $2.4 million of earnings as profits or dividends.

Wage Wars

The IRS takes the position that distributions to the owner of an S corporation should be treated as compensation to the extent they are associated with the owner's personal services or services to the company.[2] Earnings that come from the owner's investment of capital and equipment or from the work of others can be treated as profit. The case law dealing with this issue, like the case law dealing with how much compensation is too much, is mixed.

Trying to minimize amounts subject to payroll taxes may be frowned on by the IRS. But it is legal and hardly unusual. In fact, like so much else done by savvy taxpayers and their advisers, it is to be expected when faced with the choices and planning opportunities they present.

There is nothing new about this. The incentive to prefer dividend or profit distributions to payroll has been in the code since 1993. In 1993, Gingrich's rival, President Clinton, lifted the cap on earnings subject to the 2.9 percent (combined employer and employee) Medicare tax.[3] Even before that, there was a less obvious and less rewarding reason to prefer non-service pay.

Reasonableness as Art

Arguing about these issues in more than a theoretical way is time-consuming. Auditing to determine how much pay is enough (or how much is too much) is inefficient. Of course, one must draw a line between closely held and public companies. Public companies face the gantlet of section 162(m) and its $1 million deductible compensation limit.

Privately held companies face a more amorphous test. How much compensation can be deducted as reasonable compensation? By even uttering the phrase "reasonable compensation," you reveal that you are considering a closely held company.

Depending on your identity and circumstances, you may find yourself arguing whether a distribution is or is not a dividend. The "reasonable compensation" label is often used when a business is seeking to deduct payments made to officers, directors, or shareholders. Increasingly, however, that phrase suggests one of the recurring dichotomies in our tax law.

What is reasonable today and what was reasonable 30 years ago may be very different. It does not seem too cynical to suggest that virtually anything is reasonable in our post-Gordon Gekko climate. Even after the Wall Street bailouts, huge compensation packages for services rendered may not raise an eyebrow. Yet the fundamental tax principles remain largely unchanged.

Closely held companies are required to demonstrate that something paid as compensation is reasonable for it to be deductible.[4] The deduction at the corporate level (for a C corporation) has considerable value, even if payroll taxes have to be paid. But the prevalence of flow-through entities since 1986 is one reason there is a paucity of reasonable compensation tax cases these days. Another is the perception that just about any outsize compensation today is reasonable.[5]

It must be remembered that although unlimited payroll tax exposure came into the law in 1993, the incentives to favor dividend distributions from S corporations existed long before that. In 1993, when unlimited amounts of pay became subject to payroll tax, the stakes got much bigger. The IRS would argue that the corporation should have paid amounts as compensation rather than as dividends.

The early case law dealt with egregious situations in which it was clear that services were being rendered (in some cases by a sole shareholder employee). The decisions in those cases were simple, because not one penny of compensation was paid.[6] After early authority with that obvious outcome, taxpayers became at least slightly more sophisticated. They began to bifurcate payments. Planners had the S corporation pay out a relatively small amount for services rendered, with much of the corporate income passed through as dividends to the sole closely held shareholder (or handful of shareholders).

Although it is Gingrich whose name is up in lights today, he follows in some well-known footsteps. What is now unfortunately mislabeled as the "S corporation tax shelter" achieved national prominence with former Sen. John Edwards.[7] At this writing, Edwards is on trial on charges relating to alleged campaign finance violations. But during his first run for the presidency, Edwards' fact pattern was almost identical to Gingrich's today.

Edwards reportedly paid himself a salary of $360,000 (on which payroll taxes were paid). He distributed the bulk of the income (about $5 million) as a distribution of S corporation profits. The colloquy in the tax press at the time generally concluded that it was largely a factual question of how much compensation was reasonable. Some of the income Edwards received was surely allocable to his own legal services. Some was surely attributable to his ownership of (and capital invested in) the law firm.

Interestingly, management services rendered by Edwards, like legal services, presumably would be viewed as part of the compensation element. For each of those elements, how much pay is reasonable, and how much is too little? Those questions are not easy to answer.

At the time, the press suggested it would be hard for the IRS to show that the amounts Edwards had the corporation distribute to himself as dividends were actually disguised compensation. Yes, it is hard for the IRS in such a case. In fact, these cases may be more difficult than traditional reasonable compensation cases.

Dr. Watson, I Presume?

A recent case serves as a suitable exemplar for the S corporation payroll tax battleground of current law. In *David E. Watson PC v. United States*,[8] 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 received only $24,000 in salary from the firm in each of 2002 and 2003. However, the dividends Watson received were high. 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, he 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. 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 dividend payments were really remuneration for services performed or were something else.

Watson appealed to the Eighth Circuit, which affirmed.[9] The court required Watson to treat $91,044 per year as his compensation (which was thus subject to the 15.3 percent Social Security and Medicare taxes), rather than the $24,000 he claimed. One of the primary explanations for the decision was Watson's profession and experience. The court noted that Watson was an exceedingly qualified accountant with an advanced degree and nearly 20 years experience in accounting and taxation.

Watson argued that he and the firm only *intended* $24,000 to be his pay for services and that this intent controlled. That simply didn't fly. After all, Watson worked 35 to 45 hours per week as one of the primary earners in a reputable firm that had earnings much greater than comparable firms. In fact, the firm grossed more than $2 million in 2002 and nearly $3 million in 2003.

By any measure, $24,000 was unreasonably low compared with other similarly situated accountants. Besides, given the firm's financial position and Watson's experience and contributions, a $24,000 salary was exceedingly low compared with the roughly $200,000 distributed to his professional corporation in 2002 and 2003. All that led the district court to conclude that the fair market value of Watson's services was $91,044, and the court of appeals surely couldn't find that conclusion to be clearly erroneous.

Although Watson may be a noteworthy case, it certainly isn't the only one. In *Joly v. Commissioner*,[10] the Sixth Circuit held that an S corporation's distributions to its controlling shareholders were wages. The court even ignored an express written agreement that any excess amounts would be treated as loans to the shareholder. The Tax Court has also decided many similar cases.[11]

Yet in many ways, a case like *Watson* is as helpful for what it *allows* as for what it does not. On the facts, it might have seemed appropriate for the court to hold that all the pay was wages, not just $91,000. With the court's blessing, Watson was able to avoid payroll taxes on approximately $200,000 spread between 2002 and 2003. That's pretty impressive, particularly considering that Watson did a mediocre job of justifying his compensation-to-dividend split.

Reasonable Compensation Facts

The cases helping to demarcate the line between reasonable compensation and dividend payments in the S corporation world are many. However, they share some noteworthy characteristics. More often than not, if the payment of wages is de minimis or nonexistent, a putative dividend payment may be recharacterized.

In contrast, when it appears that the corporate entity did not intend to compensate the shareholder, the payment may pass muster as a dividend. In between, it is not as clear. The significant fact patterns described in these cases include the following:

- Two shareholders performed services for a corporation and drew no salary, but arranged for the corporation to pay them as "dividends" the amount they would have received as reasonable compensation for services performed. The IRS ruled the dividends were wages and subject to payroll taxes. Rev. Rul. 74-44, 1974-1 C.B. 287.
- Two shareholders performed services for a corporation that at the time no longer qualified as an S corporation. They received distributions they did not report as salary income. On learning that the payments wouldn't be treated as passthrough distributions, the taxpayers sought to treat them as deductible compensation by the corporation. The Tax Court held that when the payments were made, they weren't intended as compensation for services. Therefore, the payments were not deductible. *Paula Construction Co. v. Commissioner*, 58 T.C. 1055 (1972).
- An attorney created an S corporation of which he was the sole director, shareholder, and full-time employee. He took no salary, receiving instead dividend payments from the corporation. Since the corporation paid the attorney (the only significant employee) no salary for substantial services, the court held the dividends were in fact wages subject to payroll taxes because the "dividends" functioned as remuneration for employment. *Joseph Radtke S.C. v. United States*, 895 F.2d 1196, 1197 (7th Cir. 1990).
- The president, treasurer, and director of an accounting firm, who, with his wife, was the only stockholder of an S corporation, "donated" his services to the corporation and withdrew earnings in the form of dividends. Those payments were recharacterized as wages. *Spicer Accounting Inc. v. United States*, 918 F.2d 90, 93 (9th Cir. 1990).
- The president of a construction company owned substantially all of the company's stock. He received and reported not only a salary but also disbursements from the company (roughly equal to his salary) for his own personal use and benefit. The Tax Court held that those disbursements were dividends, not wage income, because amounts beyond the taxpayer's stated salary were not intended to be paid as compensation. *Electric & Neon Inc. v. Commissioner*, 56 T.C. 1324 (1971).
- Surgeon shareholders owned a personal service corporation when other surgeons were employees. The IRS argued that the surgeons were treating as compensation profit attributable to services performed by non-shareholder surgeons. Those payments should be treated as a nondeductible, disguised dividend rather than as deductible compensation. The Tax Court agreed, finding that the salaries paid to the shareholder surgeons exceeded reasonable allowances for services actually rendered by them and that those amounts therefore were not deductible by the corporation. *Pediatric Surgical Assoc. PC v. Commissioner*, T.C. Memo. 2001-81, *Doc 2001-9587*, *2001 TNT 64-13*.
- A doctor performed substantial services on behalf of an S corporation of which he was sole shareholder and president. He received no wages, only distributions of corporate net income. The Tax Court found that the payments constituted remuneration for services performed by the doctor and were subject to wage withholding. *Veterinary Surgical Consultants PC v. Commissioner*, 117 T.C. 141 (2001), *Doc 2001-26327*, *2001 TNT 200-9*.
- The sole shareholder and director of an S corporation received an annual salary of $19,000 in year 1 and $30,000 in years 2 and 3. The shareholder also received dividends of $47,000 in year 1, $50,000 in year 2, and $50,000 in year 3. The district court agreed with the IRS that the salary was unreasonably low, and it upheld the assessment of employment taxes, interest, and penalties against the corporation after recharacterizing portions of the dividend payments as wages. *JD & Associates Ltd. v. United States*, No. 3:04-cv-59 (D.N.D. May 19, 2006).

Those and other taxpayers might have benefited from the details set out in IRS fact sheet FS-2008-25.[12]

IRS Fact Sheet FS-2008-25

FS-2008-25 provides information on this very issue, earmarking the topic for S corporations and their owners. However, if this is the best guidebook we have for sifting through the figures, that should tell us something fundamental. This area isn't going to be easy to handle on audit or otherwise.

What is the proper tax treatment when officers of the S corporation perform services for the entity? The fact sheet warns S corporations not to attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, or loans rather than wages. It goes on to say that the fact that an officer is also a shareholder does not change the requirement that payments to that officer be treated as wages.

Pay is pay. The fact sheet stresses that the courts have "consistently" held that S corporation officers/shareholders who provide more than minor services to the company and receive (or are entitled to receive) payment are employees. That means their compensation is subject to federal employment taxes. The IRS suggests that this means all compensation.[13]

How Much Is Reasonable?

Traditional reasonable compensation tax cases are relatively rare these days. By "traditional reasonable compensation cases" we mean cases in which the taxpayer is arguing that the company can deduct a whopping payment because it is reasonable compensation for services rendered. The reverse variety of reasonable compensation case asks how much compensation is too little.

These cases seem to be hatching more and more. FS-2008-25 may be intended to scare small businesses into paying out all amounts as compensation. Most tax advisers are likely to think that reaction would be going too far.

Indeed, the fact sheet itself states that distributions and other payments by the S corporation to officers must be treated as wages "to the extent the amounts are reasonable compensation for services rendered to the corporation." The question, of course, is just what constitutes reasonable compensation. There's the conundrum again.

The taxpayer has an incentive to err on the low side of reasonable. This compares with the old days in a C corporation context, when the taxpayer had an incentive to err on the high side of reasonable. But within this vast frontier, it is simply unclear how one should go about setting the reasonable amount.

The fact sheet acknowledges that there are no specific guidelines for what constitutes reasonable compensation (viewed from either perspective) in the code or regulations. This requires nitty-gritty factual analysis. With a kind of all-facts-are-relevant expansiveness reminiscent of independent-contractor-versus-employee analysis, FS-2008-25 simply lists a variety of factors that the courts have considered in determining what is reasonable. They include:

- training and experience;
- duties and responsibilities;
- dividend history;
- time and effort devoted to the business;
- payments to non-shareholder employees;
- the timing and manner of paying bonuses to keep personnel;
- compensation agreements;
- the amount comparable businesses pay for similar services; and

- using a formula to determine compensation.

The NEWT Act

One proposal to address the S corporation compensation conundrum nearly became law in 2010 as part of the Unemployment Compensation Extension Act of 2010 (also known as the American Jobs and Closing Tax Loopholes Act of 2010), H.R. 4213. It was decidedly not Solomonic in approach. Just tax it all, the bill said.

The proposal was projected to raise $11 billion over 10 years by automatically imposing payroll tax on *all* the distributions to owners of some professional service S corporations. Over strong objections, the Senate eventually dropped the proposal. Yet with the Gingrich-linked resurgence, the issue returned and the dollars are not insignificant. A new bill has surfaced. Ways and Means Committee member Fortney Pete Stark, D-Calif., reintroduced the legislation with the NEWT Act.

Like its 2009 predecessor, the NEWT Act would clamp down on the owners of some S corporations. Shareholders who provide services to disqualified S corporations would face self-employment tax on the distributions they receive from the corporation even if those payments are characterized as dividends or profits. Because the self-employment tax embodies both the employer's and employee's share of employment tax, it would correspond to wage treatment.

The NEWT Act would cut a wide swath through closely held companies via a broad definition of disqualified S corporations. As proposed, disqualified S corporations would include:

- any S corporation that is a partner in a professional service partnership, if the services are substantially all of the corporation's activities; 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 in which substantially all 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. Considering that "consulting" is among the culprits named, it is a broadly applicable list.

As if this weren't enough, Stark has also proposed family attribution. If family members receive dividend or profit distributions from the S corporation, there would be more tax to pay -- even if they don't provide any services to the corporation. In that case, the service provider would be hit with self-employment tax on *all* the monies paid to the family members.

S Corps and Student Loan Interest Rates

As if Gingrich's presidential and corporate travails were not enough, Congress also has decided that imposition of a payroll tax on S corporation distributions may solve the federal student loan interest rate issues. Senate Majority Leader Harry Reid, D-Nev., introduced the Stop Student Loan Interest Rate Hike Act of 2012 (S. 2343) on April 24, 2012.

Like the NEWT Act, Reid's bill seeks to offset a scheduled increase in federal student loan interest rates by forcing individuals with incomes exceeding $250,000 to include, for purposes of employment taxes, income received from S corporations in professional services businesses. However, this bill appears to have suffered the same fate as its predecessors. On May 8, 2012, the full Senate blocked Reid's bill from moving forward.[14] Nevertheless, both the NEWT Act and Reid's student loan legislation demonstrate that

S corporation compensation remains a hobby horse to which Congress can perennially return when seeking additional revenues or political points.

Conclusion

What is reasonable, too high, or too low is unlikely to be the subject of universal agreement. There will usually be subjective criteria, and it sometimes seems that virtually anything is reasonable to someone. That suggests that this area, not unlike disputes among appraisal specialists over valuation matters, may come down to a battle of the experts.

In that sense, some variety of deemed solution that treats some or all distributions as pay may be efficient, even if it is unpopular. After all, the taxpayer incentive to err on the side of noncompensation is clear. Indeed, it is increasing. Starting in 2013, under President Obama's new healthcare reform law, married couples with compensation exceeding $250,000 (and single taxpayers with more than $200,000 in compensation) are destined to pay an additional 0.9 percent Medicare surtax on their pay above those amounts.[15]

That may be just one more reason the line between the reasonable and the unreasonable is likely to get even murkier.

FOOTNOTES

[1] *See* section 1402.

[2] *See*, *e.g.*, Instructions to Form 1120S, "U.S. Income Tax Return for an S Corporation."

[3] Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66).

[4] *Elliotts Inc. v. Commissioner*, 716 F.2d 1241, 1243-1245 (9th Cir. 1983).

[5] *See, e.g., Menard Inc. v. Commissioner*, 560 F.3d 620 (7th Cir. 2009), *Doc 2009-5325*, *2009 TNT 46-9*.

[6] *See Spicer Accounting Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990); *see also Joseph Radtke S.C. v. United States*, 712 F. Supp. 143 (E.D. Wis. 1989), *aff'd*, 895 F.2d 1196 (7th Cir. 1990).

[7] *See* Kenneth A. Gary, "Despite Media Reports, Sen. Edwards' S Corp. Not Abusive Tax Shelter," *Tax Notes*, July 26, 2004, p. 365, *Doc 2004-15186*, or *2004 TNT 144-2*.

[8] 714 F. Supp.2d 954, 955 (S.D. Iowa 2010), *Doc 2011-530*, *2011 TNT 7-14*, *aff'd*, 668 F.3d 1008 (8th Cir. 2012), *Doc 2012-3783*, *2012 TNT 36-12*.

[9] 668 F.3d 1008.

[10] 211 F.3d 1269 (6th Cir. 2000), *Doc 2000-9384*, *2000 TNT 61-20*.

[11] *See Joseph M. Grey Public Accountant PC v. Commissioner*, 119 T.C. 121 (2002), *Doc 2002-21091*, *2002 TNT 180-12*, *aff'd*, No. 02-4417 (3d Cir. 2004), *Doc 2004-7691*, *2004 TNT 68-11*; *see also Greenlee Inc. v. United States*, 661 F. Supp. 642 (D.C. Colo. 1985); *Olde Raleigh Realty Corp. v. Commissioner*, T.C. Summ. Op. 2002-61, *Doc 2002-12954*, *2002 TNT 104-8*.

[12] *Doc 2008-24635*, *2008 TNT 226-6*.

[13] *See Yeagle Drywall Co. Inc. v. Commissioner*, No. 02-1132 (3d Cir. 2002), *Doc 2002-27688*, *2002 TNT 244-12*; *see also Nu-Look Design Inc.*, 356 F.3d 290 (3d Cir. 2004), *Doc 2004-1659*, *2004 TNT 18-7*.

[14] *See Doc 2012-9801*, *2012 TNT 90-2*.

[15] *See* section 10906 of the Patient Protection and Affordable Care Act, P.L. 111-148.

END OF FOOTNOTES