Compensation Reclassification Risks for C and S Corporations

STEPHEN R. LOONEY AND RONALD A. LEVITT

C corporation shareholder-employees face the risk that a portion of their wages could be reclassified as dividends subject to double taxation if their compensation is unreasonably high. In contrast, S corporation shareholder-employees face the risk that a portion of the amounts distributed to them as dividends could be reclassified as wages subject to Social Security taxes if their compensation is unreasonably low.

When tax practitioners think about "unreasonable compensation," they normally are envisioning unreasonably *high* compensation being reclassified as dividends so as to be subject to the double tax to which C corporations and their shareholders are generally subject. In the S corporation context, however, that concept is basically turned upside-down, where the question is whether the IRS can successfully argue that the S corporation has paid unreasonably *low* compensation to its shareholder-employees so as to reclassify amounts distributed as dividends to the shareholder-employees of S corporations as wages subject to Social Security taxes, including the increased 3.8% hospital insurance portion of FICA taxes imposed on the wages of certain higher income taxpayers. This article will begin by looking at unreasonably high compensation in the C corporation context, including relevant statutes, regulations, administrative guidance and case law, which encompasses application of the compensatory intent test, the use of the multi-factor test to determine the reasonableness of compensation and the more recent application of the independent investor test by the courts to determine the reasonableness of compensation in the C corporation setting. The article will also focus on administrative rulings and case law in the S corporation context when the compensation paid to shareholder-employees has been found to be unreasonably low, resulting in the recharacterization of all or a portion of the dividend distributions made by the S corporation as wages subject to

Social Security taxes. Finally, the article will briefly look at the one instance in which the IRS might assert a traditional unreasonably high compensation argument in the S corporation context when the S corporation has converted from C corporation status to S corporation status and is subject to the built-in-gain tax.

UNREASONABLY HIGH COMPENSATION AND C CORPORATIONS

The relevant authority in determining the deductibility of compensation is Section 162(a)(1), which allows a deduction for ordinary and necessary expenses paid or incurred during a tax year in carrying on a trade or business, including a "reasonable allowance" for salaries or other compensation for personal services actually rendered.

Reg. 1.162-7(a) provides 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. 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.[1] Although a majority of the cases focus on the reasonableness of the compensation paid, and do not focus separately on the intent of the payment, several cases have discussed the intent requirement.

Compensatory Intent

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 records of the corporation as salary.

The leading case in this area is *Paula Construction Co.*, 58 TC 1055 (1972), *aff'd* 474 F.2d 1345, 31 AFTR2d 73-926 (CA-5, 1973). In *Paula Construction*, the shareholder-employees believed that the corporation's Subchapter S status was in effect (it had been inadvertently and retroactively terminated for the years in issue), and as such, did not reflect the corporation's distributions as compensation in the corporate records or its tax returns as it believed such distributions would be nontaxable distributions from the S corporation to its shareholders. In holding that the corporation was not entitled to a compensation deduction for the amounts paid, the Tax Court stated that "it is now settled law that only if payment is made with the intent to compensate is it deductible as compensation. ... Whether such intent has been demonstrated is a factual question to be decided on the basis of the particular facts and circumstances of the case." See also *Electric & Neon, Inc.*, 56 TC 1324 (1971), *aff'd* 496 F.2d 876, 34 AFTR2d 74-5590 (CA-5, 1974) and *International Capital Holding Corp.* TCM 2002-109, in which the Tax Court found that payments made to a management company were intended to compensate the recipient for services rendered. Because the IRS conceded the reasonableness of the amount paid, the payments were found to be deductible. However, see *Neonatology Associates P.A.* 299 F.3d 221, 90 AFTR2d 2002-5442 (CA-3, 2002), *aff'g* TCM 2001-270, in which the Third Circuit affirmed the Tax Court in three cases on VEBA deductions by medical corporations, holding that the corporations could not deduct payments made to the VEBAs because the VEBAs were not designed to provide benefits to employees, but were instead intended to benefit the sponsoring owners of the VEBAs. The court treated the payments as constructive dividends. These cases make it clear that it is absolutely necessary to properly document payments made by a corporation to its shareholder-employees as compensation (rather than as dividend distributions) in order for the payments to be deductible.[2]

Reasonableness of Compensation and the Multi-Factor Test

The leading case in the unreasonable compensation area is *Mayson Manufacturing Co.*, 178 F.2d 115, 38 AFTR 1028 (CA-6, 1949), which sets forth the following nine factors to be used in evaluating the reasonableness of the amount of an employee's compensation. These factors have generally been used in one form or another in almost all subsequent cases analyzing the reasonableness of compensation.

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 and comparable businesses.
8. The salary policy of the taxpayer for all employees.
9. The compensation paid to the particular employee in prior years when the business is a closely-held corporation.

Another significant case using the multi-factor test is *Elliotts Inc.*, 716 F.2d 1241, 52 AFTR2d 83-5976 (CA-9, 1983), *rev'g* TCM 1980-282. *Elliotts* involved a corporation that sold and serviced equipment manufactured by John Deere Company and other manufacturers. The taxpayer's sole shareholder, Edward Elliotts, was found to have total managerial responsibility for the taxpayer's business and was the ultimate decision and policy maker and, in addition, performed the

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1 See also Regs. 1.162-7(b)(1), -7(b)(2), -7(b)(3), -8, and -9.

2 See also, FSA 1994-16, 1994 WL 1725566 (addressing compensatory intent in the context of a law firm); FSA, 1995 WL 1918240; FSA 200042001; GCM 36801 (8/13/76); and *Nor-Cal Adjusters*, 34 AFTR2d 74-5834 (CA-9, 1974).

functions usually delegated to sales and credit managers. He worked approximately 80 hours each week.

The taxpayer had compensated Elliotts by paying a base salary plus a year-end bonus, which, since incorporation, had been fixed at 50% of net profits (before deduction for taxes and management bonuses). On audit of the 1975 and 1976 tax years, the IRS determined that a portion of the compensation paid to Elliotts was unreasonable in amount.

After reviewing the testimony and statistical evidence presented by the parties, the Tax Court concluded that the payments to Elliotts, in addition to providing compensation for personal services, were intended in part to distribute profits and were, therefore, nondeductible dividends.

The taxpayer appealed the Tax Court's determination to the Ninth Circuit. The Ninth Circuit's opinion is important for three main reasons. First, the Ninth Circuit recognized that in analyzing the two-prong test for deductibility under Section 162(a)(1), a taxpayer's proof that the amount paid is reasonable will often result in similar proof that the purpose for which the payments are made is compensatory.

The second reason *Elliotts* is important is that the court rejected any requirement that a profitable corporation should use part of its earnings to pay dividends. First, the court stated that no statute requires profitable corporations to pay dividends. Second, any such requirement is based on the faulty premise that shareholders of a profitable corporation will demand dividends. Third, it may well be in the best interest of the corporation to retain and invest its earnings.

Although the first two issues outlined above are important, *Elliotts* is probably more important for categorizing the nine *Mayson* factors discussed above into the following five categories:

1. The employee's role in the company, including, as relevant to such consideration, the position held, hours worked and duties performed by the employee, in addition to the general importance of the employee to the success of the company.
2. An external comparison of the employee's salary with those paid by similar companies for similar services. Thus, if a shareholder is performing the work of three employees, for example, the relevant comparison would be the combined salaries of those three employees in a similar corporation.
3. The character and condition of the company as indicated by its sales, net income, and capital value, together with the complexities of the business, as well as general economic conditions.
4. Whether some relationship exists between the corporation and its shareholder-employee that might permit the company to disguise nondeductible corporate distributions of income as salary expenditures deductible under Section 162(a)(1). This category employs the independent investor standard, which provides that if the company's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company as disguised salary.
5. A reasonable, long-standing, consistently applied compensation plan is evidence that the compensation paid for the years in question is reasonable.

Following *Mayson* and *Elliotts*, numerous cases have applied the multifactor test in determining the reasonableness of compensation.[3]

Regs. 1.162-7(b)(1) and -8 provide that it is likely that a compensation payment is in fact a dividend distribution of excessive comepensation payments correspond or bear a close relationship to the recipient's stock holdings in the company. The "automatic dividend" rule set forth in *Charles McCandless Tile Service*, 422 F.2d 1336, 25 AFTR2d 70-870 (Ct. Cl., 1970), was rejected by the Ninth Circuit in *Elliotts* as well as by the IRS in Rev. Rul. 79-8, 1979-1 CB 92. Although there is no automatic dividend rule, the dividend history of the corporation and whether the compensation (bonuses) is paid in proportion to the stock ownership of the shareholder-employees are important factors in the multi-factor test. The fact that compensation payments are not made in proportion to the shareholder-employee's stock ownership does not, however, preclude a finding that the compensation payment actually constituted a dividend.[4]

Reasonableness of Compensation and the Independent Investor Test

In *Elliotts*, the five factors used by the court in determining the reasonableness of compensation paid by the corporation to its shareholder-employees employed an independent investor standard. That standard provides that if the corporation's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company as disguised salary. This is referred to as the "independent investor test."

In *Dexsil Corp.*, 147 F.3d 96, 81 AFTR2d 98-2312 (CA-2, 1998), *vacating and remanding* TCM 1995-135, the Second Circuit vacated and remanded a Tax Court decision finding unreasonable employee compensation in the context of a closely held corporation. In reaching its decision, the court quoted its opinion in *Rapco Inc.*, 85 F.3d

STEPHEN R. LOONEY is a shareholder and chairman of the tax department of the Orlando law firm of Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth, P.A. RONALD A. LEVITT is a shareholder in the Birmingham, Alabama, law firm of Sirote & Permutt, P.C. Both authors are a Past Chair of the ABA Tax Section's S Corporations Committee, and have previously written for The Journal. The information contained in this article is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax advisor. This article represents the views and opinions of the authors only and does not necessarily represent the views or professional advice of Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth, P.A., or Sirote & Permutt, P.C. Copyright © 2015, Stephen R. Looney and Ronald A. Levitt

950, 77 AFTR2d 96-2405 (CA-2, 1996), in stating that "in this circuit the independent investor test is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed." The court thus articulated the notion that the independent investor tests is more than a mere factor in determining the reasonableness of compensation and provides the very basis for assessing reasonableness.

Other circuits have adopted the independent investor test as set forth by the Second Circuit in *Dexsil.* In *Exacto Spring Corp.*, 196 F.3d 833, 84 AFTR2d 99-6977 (CA-7, 1999), the Seventh Circuit held that the salary paid to a shareholder-employee was reasonable based on the fact that an independent investor would achieve a high rate of return even with the shareholder's salary. In following the Second Circuit's reasoning in *Dexsil*, Chief Judge Posner stated that "[b]ecause judges tend to downplay the element of judicial creativity in adapting law to fresh insights and changed circumstances, the cases we have just cited [*Dexsil* and *Rapco*] prefer to say ... that the 'independent investor' test is the 'lens' through which they view the seven ... factors of the orthodox test. But that is a formality. *The new test dissolves the old and returns the inquiry to basics.*"

Recent Cases Addressing Reasonableness of Compensation

The following sections discuss cases that take up the question of the reasonableness of compensation.

Menard. In *Menard, Inc.*, 560 F.3d 620, 103 AFTR2d 2009-1280 (CA-7, 2009), the Seventh Circuit reversed the holding of the Tax Court and found that the compensation paid by a corporation to its chief executive officer constituted reasonable compensation rather than a non-deductible dividend distribution to him.

Menard, Inc. is a Wisconsin firm that under the name "Menard's" sells hardware, building supplies, and related products through retail stores scattered throughout the Midwest. In 1998, it was the third largest home improvement chain in the United States, with only Home Depot and Lowe's being larger. It was founded by John Menard in 1962, who through 1998 was the company's chief executive officer, working 12 to 16 hours a day six or seven days a week and taking only seven days of vacation per year. Under his management, Menard's revenues grew from $788,000,000 in 1991 to $3,400,000,000 in 1998 and the company's taxable income grew from $59,000,000 to $315,000,000 during the same period. The company's rate of return on shareholders' equity in 1998 was, according to the IRS's expert, 18.8%, which was higher than the rate of return on shareholders' equity for either Home Depot or Lowe's.

Mr. Menard owned all of the voting shares in the company and 56% of the nonvoting shares, with the rest of the shares being owned by members of his family. In 1998, his salary was $157,500, and he received a profit-sharing bonus of $3,017,100 as well as a "5% bonus" that resulted in Mr. Menard receiving an additional $17,467,800.

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3 See, e.g., *Klamath Medical Service Bureau*, 29 TC 339 (1957), *aff'd* 261 F.2d 842, 3 AFTR2d 322 (CA-9, 1958); *Edwardo Catalano, Inc.*, TCM 1979-183; *LaMastro*, 72 TC 377 (1979); *Automotive Investment Development, Inc.*, TCM 1993-298; *Mortex Manufacturing Company*, TCM 1994-110; *L&B Pipe & Supply Company*, TCM 1994-187; *Thomas Curtis, M.D., Inc.*, TCM 1994-15; *C.T.I. Incorporated*, TCM 1994-82; *Mad Auto Wrecking, Inc.*, TCM 1995-153; *Boca Construction Inc.*, TCM 1995-5; *Comtec Systems, Inc.*, TCM 1995-4; *Acme Construction Co., Inc.*, TCM 1995-6; *Summit Sheet Metal Co.*, TCM 1996-563; *John L. Ginger Masonry, Inc.*, TCM 1997-251; *Eberl's Claim Service, Inc.*, 249 F.3d 994, 87 AFTR2d 2001-2075 (CA-10, 2001).

4 *See Kennedy*, 671 F.2d 167, 49 AFTR2d 82-628 (CA-6, 1982), *rev'g and remanding* 72 TC 793 (1979) and *Mulcahy, Pauritsch, Salvador & Co. Ltd.*, 680 F3d 867, 109 AFTR2d 2012-2140 (CA-7, 2012).

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The 5% bonus program (5% of the company's net income before income taxes) was adopted in 1973 by the company's board of directors at the suggestion of the company's accounting firm. There was no suggestion that any shareholder was disappointed that the company obtained a rate of return of only 18.8% or that the company's success in that year or any other year had been due to windfall factors. In addition to finding that Mr. Menard's compensation was excessive (primarily based on the compensation paid to the chief executive officers of Home Depot and Lowe's), the Tax Court found that such amounts were actually *intended as a dividend.* The Tax Court reached this conclusion because Mr. Menard's entitlement to his 5% bonus was conditioned on his agreeing to reimburse the corporation if the deduction of the bonus from the corporation's taxable income was disallowed by the IRS and because 5% of the corporate earnings year-in and year-out looked more like a dividend than a salary to the Tax Court. As will be discussed in more detail below, the Seventh Circuit found that the Tax Court's holding was based on "flimsy grounds."

In reviewing the Tax Court decision, the Seventh Circuit pointed out that a corporation is *not* required to pay dividends. The main focus of the Tax Court decision was whether Mr. Menard's compensation exceeded that of comparable CEOs in 1998. Specifically, the CEO of Home Depot was paid only $2,800,000 in 1998, and the CEO of Lowe's was paid a salary of $6,100,000 in 1998 (both of which were considerably less than the total compensation paid to Mr. Menard in 1998 of more than $20,000,000).

The Seventh Circuit found that salary is just the beginning of a meaningful comparison, because it is only one element of a compensation package. Specifically, the Seventh Circuit pointed out that a risky compensation structure implies that the executive's salary is likely to vary substantially from year to year, and that Mr. Menard's compensation could have been considerably less than $20,000,000 if the corporation did not have a good year, a possibility the Tax Court completely ignored. Additionally, the Seventh Circuit found that the Tax Court did not consider the CEOs' severance packages, retirement plans, or other perks when it compared Menard with the CEOs of Home Depot and Lowe's. The Seventh Circuit found strange the Tax Court's remark that because Mr. Menard owned the company he had all the incentive he needed to work hard without the need for a generous salary. It pointed out that under the Tax Court's reasoning, reasonable compensation for Mr. Menard might have been zero. In short, the Seventh Circuit found that for compensation purposes, the shareholder-employee should be treated like all other employees and that if an incentive bonus is appropriate for a non-shareholder employee, there is no reason why a shareholder-employee should not be allowed to participate in the same manner. Based on these considerations and the fact that an independent investor would be satisfied with an 18.8% rate of return, the Seventh Circuit concluded that Mr. Menard's compensation was *not* excessive in 1998, and that the Tax Court committed clear error in finding that Mr. Menard's compensation was unreasonable.

Multi-Pak Corp. In Multi-Pak Corp., TCM 2010-139, the Tax Court held that the compensation paid by the taxpayer's wholly owned corporation for one of the years in issue (2002) was reasonable, but recharacterized a portion of the compensation paid to the taxpayer in the other year in issue (2003) as a non-deductible dividend distribution because the amount of compensation paid to the taxpayer in that year was unreasonable.

The taxpayer, Multi-Pak Corp., was a C corporation wholly owned by Randall Unthank, who was the president, CEO, and COO for the years in issue. Mr. Unthank performed all of Multi-Pak's managerial duties and made all personnel decisions, and was in charge of Multi-Pak's price negotiations, product design, machine design and functionality, and administration. Mr. Unthank also personally oversaw the expansion of Multi-Pak's office and warehouse to accommodate Multi-Pak's growing operations.

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 2002, Multi-Pak paid total compensation of $2,020,000 to Mr. Unthank, consisting of a salary of $150,000 and a $1,870,000 bonus. In the other year at issue, 2003, Multi-Pak paid a total compensation of $2,058,000 to Mr. Unthank, consisting of a salary of $353,000 and a $1,705,000 bonus. The IRS determined in a notice of deficiency that Multi-Pak could deduct only $665,000 and $660,000 of officer compensation for 2002 and 2003, respectively, as reasonable compensation for Mr. Unthank's services during those years. Additionally, the IRS imposed Section 6662(a) accuracy-related penalties on Multi-Pak for the years in issue.

In reaching its decision, the court in *Multi-Pak* discussed and analyzed the five categories previously set forth in *Elliotts:*

1. *The employee's role in the company, including as relevant to such consideration the position held, hours worked, and duties performed by the employee, in addition to the general importance of the employee*

to the success of the company. In Multi-Pak, the Tax Court found that this factor favored the taxpayer based on Mr. Unthank's importance to Multi-Pak.

2. *An external comparison of the employee's salary with those paid by similar companies for similar services.* After an extensive analysis of the expert testimony presented by the taxpayer and the IRS, the Tax Court in Multi-Pak found that the analysis performed and the opinions expressed by both parties' experts were not persuasive or reliable, and as such, found that the comparison to the compensation paid by unrelated firms was a neutral factor which did not favor either party.
3. *The character and condition of the company as indicated by its sales, net income, and capital value, together with the complexities of the business, as well as general economic conditions.* The Tax Court found that although Multi-Pak's net income in 2002 and 2003 was low when compared to revenues, other factors such as equity, revenue, and gross profit pointed towards a successful operation, and as such, found that this factor favored the taxpayer.
4. *Whether some relationship exists between the corporation and its shareholder-employee which might permit the company to disguise nondeductible corporate distributions of income as salary expenditures deductible under Section 162(a)(1).* This category employs the independent investor standard, which provides that if the company's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company as disguised salary. As will be discussed in more detail below, the Tax Court found that this factor favored the taxpayer in 2002 but favored the IRS in 2003.
5. *A reasonable, long-standing, consistently applied compensation plan is evidence that the compensation paid for the years in question is reasonable.* The Tax Court found that in 2002 and 2003, Mr. Unthank paid himself a monthly bonus of $100,000 to $250,000 in 19 of the 24 months, in four other instances, Mr. Unthank paid himself a bonus of $50,000 or less, and in one other instance paid himself a bonus of $375,000. Additionally, Mr. Unthank's sons each were paid monthly bonuses that ranged from zero to $90,000. Based on all these facts, the Tax Court concluded that the taxpayer's payment of Mr. Unthank's bonuses was made under a consistent business policy, and as such, this factor favored the taxpayer.

In determining the rate of return that would be received by the hypothetical independent investor, the Tax Court in *Multi-Pak* divided the taxpayer's net profit (after payment of compensation and a provision for income taxes) by the year-end shareholder's equity as reflected in its financial statements. This yielded a return on equity of 2.9% for 2002 and negative 15.8% for 2003. The court concluded that, although an independent investor may prefer to see a higher rate of return than the 2.9% in 2002, an independent investor would note that Mr. Unthank was the sole reason for the company's significant rise in sales in 2002 and would be satisfied with the 2.9% rate of return. However, the court agreed with the IRS that a negative 15.8% return on equity in 2003 called into question the level of Mr. Unthank's compensation for that year. The court went on to state that when compensation results in a negative return on shareholder's equity, it cannot conclude, in the absence of a mitigating circumstance, that an independent investor would be pleased. Consequently, the court felt that reducing Mr. Unthank's salary to $1,284,104 in 2003, which would result in a return on equity of 10% in 2003, would be sufficient to satisfy an independent investor. The court therefore held that taxpayer was entitled to deduct the full $2,020,000 paid by it to Mr. Unthank in 2002 and was entitled to deduct $1,284,104 out of the original compensation of $2,058,000 paid to Mr. Unthank in 2003.

Although the Tax Court did evaluate each of the five factors set forth in the Elliotts case, it seemed to rely primarily on the independent investor test in reaching its conclusions as to the reasonableness of the compensation paid to Mr. Unthank in 2002 and 2003. Additionally, the court found that the taxpayer reasonably relied on professional advice so as to negate a Section 6662(a) accuracy-related penalty because it met each of the following tests:

1. The advisor was a competent professional who had sufficient expertise to justify reliance.
2. The taxpayer provided necessary and accurate information to the advisor.
3. The taxpayer actually relied in good faith on the advisor's judgment.

Thus, the Tax Court declined to sustain the IRS's determination as to the accuracy-related penalty.

The fact that compensation payments are not made in proportion to the shareholder-employee's stock ownership does not, however, preclude a finding that the compensation payment actually constituted a dividend.

***Mulcahy*—Independent investor test applied to professional service corporation.** In *Mulcahy, Pauritsch, Salvador & Co., Ltd.*, 680 F.3d 867, 109 AFTR2d 2012-2140 (CA-7, 2012), the Seventh Circuit, affirming the Tax Court, held that more than $850,000 paid in each of the three years in issue to entities owned

by each of the founding shareholders of an accounting firm operated as a C corporation should be recharacterized as nondeductible dividend distributions. *Mulcahy* represents the first case in which a court has applied the so-called "independent investor test" in determining reasonable compensation in the professional service corporation setting.

Under the facts of the case, an accounting firm operated as a C corporation, had 40 employees located in multiple branches, and, according to the court, had both physical capital and intangible capital (in the form of client lists and brand equity).

Although the corporation had revenues between $5 million and $7 million annually, the corporation itself had little or no income because its gross revenues were offset by deductions for business expenses, primarily compensation paid directly or indirectly to its owner-employees, which included three of the firm's accountants whose names form the name of the firm and owned more than 80% of the firm's stock (the "Founding Shareholders"). The firm reported taxable income of only $11,279 in 2001, a loss of $53,271 in 2002, and zero taxable income in 2003. In addition to the salaries received by the Founding Shareholders that totaled $323,076 in 2001, the corporation additionally paid more than $850,000 in "consulting fees" for each of the three years in issue to three entities owned by the Founding Shareholders, which in turn distributed the money to the Founding Shareholders.

The IRS did not question the salary deductions, but disallowed the consulting fees paid to the three entities owned by the Founding Shareholders as nondeductible dividends, resulting in a deficiency in corporate income tax of more than $300,000 for each of the three years in issue.

The Seventh Circuit found that the accounting firm would flunk the independent-investor test if it were to treat the consulting fees as salary expenses, because they reduced the firm's income such that the return to a hypothetical equity investor of the corporation would be zero or below zero. The court determined that although the independent investor test may not be applicable to the "typical small professional services firm," the accounting firm in issue was not a very small firm because of its physical capital, numerous employees, and intangible capital. Consequently, as stated above, the Seventh Circuit said that the Tax Court was correct to reject the firm's argument that the consulting fees were salary expenses because treating such expenses as salary reduced the firm's income, and thus the return to the hypothetical equity investor, to zero or below zero. According to the court, there was no evidence that the "consulting fees" were compensation for the Founding Shareholders' accounting and consulting services, but rather they were nondeductible dividend distributions.

The court specifically rejected the firm's argument that since the consulting fees were allocated among the Founding Shareholders in proportion to the number of hours that each worked, rather than by their stock ownership, the fees could not have been dividends. The court pointed out that whatever the method of allocation of the firm's income (in accordance with stock ownership or otherwise), if the fees were paid out of corporate income (if every compensated hour included a capital return), the firm owed corporate income tax on the net income hiding in those fees. The court specifically stated that "a corporation cannot avoid tax by using a cockeyed method of distributing profits to its owners."[5]

The court went on to state that "remarkably, the firm's lawyers *(an accounting firm's lawyers)* appear not to understand the difference between compensation for services and compensation for capital …." The court also noted its puzzlement that the firm chose to organize as a conventional business corporation in the first place, and scathingly concluded by stating "That an *accounting firm* should so screw up its taxes is the most remarkable feature of the case."

As demonstrated by *Mulcahy*, it is very difficult, if not impossible, for most professional corporations to meet the independent investor test when the corporation distributes all or substantially all of its income in the form of compensation to its shareholder-employees (in which case the return for the independent investor would be 0%). *Mulcahy* represents yet another tool in the IRS's arsenal for attacking compensation paid to the shareholder-employees of a professional services corporation. In addition, the IRS has the ability to attack compensation paid to the shareholders of a professional services corporation based on the compensatory intent prong of Reg. 1.162-7(a), as demonstrated by *Richlands Medical Association*, TCM 1990-660 and *Pediatric Surgical Associates, P.C.*, TCM 2001-81. Based on the rate changes made by the American Taxpayer Relief Act of 2012, the highest marginal combined tax rate applicable to C corporation earnings distributed as dividends will be 48%. Additionally, if such earnings are distributed (or deemed distributed) as dividends to the C corporation's shareholders, such dividends will potentially be subject to the new 3.8% net investment income tax imposed on higher earning taxpayers. By taking into account the additional 3.8% net investment income tax, the maximum marginal rate on a C corporation's earnings distributed as dividends to its shareholders is 50.47%.[6]

Thousand Oaks. In *Thousand Oaks Residential Care Home I, Inc.*, TCM 2013-10, the Tax Court, applying the five-factor test set forth in *Elliotts*, as well as the independent investor test, disallowed a large portion of the compensation paid to the shareholders of a C corporation.

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5 See also, *Kennedy*, 671 F.2d 167, 49 AFTR2d 82-628 (CA-6, 1982), *rev'g and remanding* 72 TC 793 (1979) (The fact that compensation payments are not made in proportion to the shareholder-employee's stock ownership does not preclude a finding that the compensation payment actually constituted a dividend.).

6 See Looney and Levitt, "Operation of the Professional Corporation 2010: Reasonable Compensation Issues, for Professional and Other Service Businesses," New York University 69th Institute on Federal Taxation, May 2011. See also the recently issued decision in *Midwest Eyes Center, S.C.*, TCM 2015-53, in which the Tax Court disallowed $1 million of a $2 million bonus paid to the physician-sole shareholder of a professional corporation.

In *Thousand Oaks*, the taxpayers (Mr. and Mrs. Fletcher) owned and operated an assisted living facility for a number of years prior to selling it to a third party. Following the sale, the taxpayers continued to be employed at the facility by the new owner. For the years in issue, (2003-2005), the corporation paid Mr. Fletcher W-2 wages of $200,000, $200,000, and $30,000, respectively. Additionally, the corporation contributed $191,433 and $259,506 to a pension plan for the benefit of Mr. Fletcher in 2003 and 2004, respectively, for a total compensation package of $880,939. The corporation paid Mrs. Fletcher W-2 wages of $200,000, $200,000 and $30,000, for 2003, 2004 and 2005, respectively. Additionally, the corporation contributed $191,433 and $198,915 to a pension plan for the benefit of Mrs. Fletcher in 2003 and 2004, respectively, for a total compensation package of $820,348. The board of director minutes for the years in issue stated that the compensation to the taxpayers was approved for payment of back salaries that were not paid in prior years due to insufficient cash flow.

The IRS contended that the compensation packages paid to the taxpayers were not reasonable for the 2003, 2004, and 2005 tax years and disallowed the deductions for all of the compensation. The taxpayers, on the other hand, argued that the compensation paid in those years was reasonable and included "catch-up" payments for prior years in which they were undercompensated.

In its decision, the Tax Court did find that compensation for prior years' services is deductible in the current year as long as the employee was actually undercompensated in prior years and the current payments are intended for past services. Additionally, the court stated that when the compensation was actually for prior years of service, it does not need to be reasonable in the year it is actually paid.

The court then went through an analysis of the five broad factors set forth in *Elliotts*. It also specifically stated that in the Ninth Circuit, where an appeal in the taxpayers' case would lie, the independent investor test must also be taken into account. After analyzing the five factors, the court then focused on the independent investor test. Citing a number of cases, the court found that a return on investment of between 10% and 20% tends to indicate that compensation was reasonable. In particular, it stated that because the corporation in issue was a small highly leveraged business purchased with a large amount of debt, a hypothetical investor might be satisfied with a 10% return on his investment. Consequently, the court, using a 10% rate of return, backed into the reasonable compensation to which the taxpayers were entitled, disallowed a total of $282,615 of compensation paid to them.[7]

It is very difficult, if not impossible, for most professional corporations to meet the independent investor test when the corporation distributes all or substantially all of its income in the form of compensation to its shareholder-employees.

K&K Veterinary Supply. In *K&K Veterinary Supply, Inc.,* TCM 2013-84, the Tax Court, siding with the IRS's expert, recharacterized a portion of the salaries paid to the sole shareholder of a C corporation and to other members of his family, as well as rental payments made by the corporation to another entity wholly owned by the shareholder, as non-deductible dividends. The C corporation was a wholesale distributor of animal health products for large animals (swine, sheep, goats, and horses); lawn and garden products; farm hardware; pet supplies; and products for farm stores and related dealers. The corporation was wholly owned by Jay Lipsmeyer, who served as president, co-chief executive officer and co-chief operating officer of the corporation. His wife, Melissa Lipsmeyer, served as vice president, secretary, and assistant chief financial officer of the corporation, while his brother, David Lipsmeyer, served as the corporation's senior vice president of sales and co-chief executive and co-chief operating officer. Jay Lipsmeyer's daughter, Jennifer Stewart, served as the corporation's chief financial officer.

In a departure from the opinions above, which applied the "independent investor" test, the Tax Court, in determining reasonable compensation, applied the multi-factor test to determine reasonable compensation for the officers of the corporation. Citing *Charles Schneider & Co., Inc.,* 500 F2d 148 (CA-8, 1974), *aff'g* TCM 1973-130, the court stated that various factors should be considered in determining the reasonableness of compensation, such as: (1) the employee's qualifications, (2) the nature, extent and scope of the employee's work, (3) the size and complexity of the business, (4) prevailing general economic conditions, (5) the employee's compensation as a percentage of gross and net income, (6) the employee-shareholder's compensation compared with distributions to shareholders, (7) the employee-shareholder's compensation compared with that paid to non-shareholder employees, (8) prevailing rates of compensation for comparable positions in comparable concerns, and (9) comparison of compensation paid to a particular shareholder-employee in previous years when the corporation has a limited number of officers.

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[7] Contrast *Thousand Oaks* with *Aries Communications Inc. & Subs.*, TCM 2013-97(discussed below) in which the Tax Court found a return of 10%-20% reasonable, but still found a portion of the compensation to be unreasonable based on the application of the multi-factor test.

Because there is a lack of arms-length bargaining, the court additionally stated that special scrutiny must be given to situations in which a corporation is controlled by the employees to whom the compensation is paid.

In reaching its decision, the Tax Court evaluated all of these factors, and looked primarily to the testimony given by the expert witnesses. After considering the reports of the taxpayer's expert and the IRS's expert, the court found the IRS's expert's report persuasive and accepted his conclusions as to reasonable compensation for each of the officers for the years in issue, 2006 and 2007, which resulted in the balance of the compensation being treated as non-deductible dividend distributions to the sole shareholder.

The court then considered the deductibility of the rental payment made by the corporation to the related entity owned by the sole shareholder of the corporation. The court stated that in determining whether the payments in issue were rental payments deductible under Section 162(a)(3), the "basic question is … whether they were in fact rent rather than something else paid under the guise of rent."[8] Again, the taxpayer and the IRS had their experts testify as to whether the rental payments were reasonable. Once again, the court accepted the position taken by the IRS's expert as to reasonable rent, and treated the balance of the rental payments as non-deductible dividends to the sole shareholder of the corporation.

Aries Communications. In *Aries Communications, Inc. & Subs.*, TCM 2013-97, the Tax Court held that the compensation paid to a communications corporation's sole shareholder was unreasonable and upheld an accuracy-related penalty. The tax year at issue was the fiscal year ending 8/31/04.

The case involved compensation paid to N. Arthur Astor, the president, CEO, CFO, and sole shareholder of Aries Communications, in his capacity as general manager of a number of radio stations owned by Aries and its subsidiaries, Orange Broadcasting Corp. and North County Broadcasting (collectively, Aries). Astor had worked in radio broadcasting in various capacities for 60 years. As the key employee and hands-on owner-operator, Astor made decisions regarding personnel, programming, sales, and acquiring and maintaining FCC licenses, and he negotiated directly with lenders and outside advisors.

Astor's personal services also included negotiating purchases and sales of individual radio stations, resulting in prices far exceeding the buyers' original offers (e.g., increased to $18 million from $12 million). Astor personally guaranteed a $20 million loan for Aries, which precipitated the sales of two radio stations as part of a forbearance agreement with the lender. There were a number of interparty loans between Astor and Aries.

Between the years 1992 and 2002, Aries was losing increasing amounts of money. It sold a radio station in each of the years 2003 and 2004 and was profitable in those years; however, Aries began losing money again in the succeeding years.

For the year at issue, fiscal year 2004, the IRS disallowed $6,086,752 of Aries' claimed Section 162 deduction for compensation paid to Astor, and determined a deficiency of $2,676,002 and a Section 6662(a) accuracy-related penalty of $535,200. Aries petitioned the Tax Court and argued in part that the amount paid to Astor in fiscal year 2004 included catch-up amounts for the three prior years; thus, the court evaluated the reasonableness of Astor's compensation for FY 2001 through FY 2004.

The court determined that there was no doubt that Astor was the most valuable employee of Aries, and that at least a portion of the compensation paid to him was for services actually rendered. To determine whether the compensation was reasonable, the court applied the five factors enunciated by the court in *Elliotts.* The court also applied an additional factor: Whether an independent investor would be willing to compensate the employee as the taxpayer compensated the employee, based on all the facts and circumstances.

With respect to the first factor (the employee's role in the company), the court determined that Astor was a hands-on, owner-operator actively involved in managing many aspects of Aries' day-to-day operations. His business acumen and experience resulted in successful investments for Aries, including acquisition of FCC licenses and the successful sales of two radio stations. The first factor thus weighed in favor of Aries.

For the second factor (comparison with similar companies' salaries), the parties provided experts with divergent opinions regarding reasonable compensation. Aries provided two experts and the IRS provided one expert, each of whom used linear regression as a tool to compare industry income and compensation. The experts agreed that external comparisons were difficult because Aries was one of the few companies in the industry in which the owner was also the operator, and that Astor was underpaid during the four years evaluated by the court. The experts also agreed that Astor was underpaid in previous years, and the court averaged their conclusions. However, the experts disagreed regarding the reasonableness of the $6,697,700 bonus paid to Astor during the year at issue. The court, using its judgment and based on the evidence in the record, determined that an appropriate bonus would be $2 million. This factor weighed against Aries.

For the third factor (character and condition of the company), the court found that Aries was a large asset-laden complex business holding multiple subsidiaries, each with its own radio station. The court noted that Aries lost money in all years except the years it sold radio stations, that it was deeply in debt, and that it had to borrow money from Astor even during the year it paid him the bonus at issue. The court concluded that this bleak financial situation suggested that Aries was thinly capitalized,

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8 See *Place*, 17 TC 199 (1951), *aff'd* 199 F.2d 373, 42 AFTR 701 (CA-6, 1952).

which cast a shadow on the substance of the transaction. This factor also weighed against Aries.

The fourth factor (potential conflicts of interest) concerns whether a relationship exists between the employee and the company that may permit the disguise of nondeductible corporate distributions as salary expenditures. Noting a lack of specific evidence in the record regarding whether Aries had ever paid dividends to Astor, the court determined that such a relationship did exist. Also, the various related-party loans and Astor's personal guarantee of the $20 million debt made it difficult to discern the true capital structure and equity status of the corporate entities. Further, although Astor negotiated the highest price for the sale of the radio station, just as an independent investor would, he had significant interest in receiving the reward as deductible salary instead of a nondeductible dividend. This factor again weighed against Aries.

The court found the fifth factor (internal consistency) to be neutral. The court said that the amount of Astor's bonus was "suspect" because it was not paid under a structured formal plan and was determined at the end of the year when Aries' profits and potential income tax liabilities could be predicted. However, no employees within the corporation had comparable duties, and the compensation included amounts for prior years of hard work for which he was undercompensated.

Finally, with respect to the additional factor (the independent investor), the court considered what a reasonable return on investment for a hypothetical independent shareholder would be. Citing case law, the court determined that a return on investment of 10%-20% tends to indicate compensation is reasonable. Aries was a highly leveraged business, but possessed assets, such as the FCC licenses, that were likely to appreciate. Further, it was unclear from the record what Astor's initial investment was and the interparty loans made it difficult to determine the return on investment. Nevertheless, the court's review of Aries' net income after paying compensation revealed that retained earnings would have been almost enough to satisfy an independent investor at 20%. This factor weighed in favor of Aries.

Based on all the facts and circumstances, the court concluded that Astor's compensation was unreasonable for the year at issue, and not deductible to Aries in its entirety. The court computed an amount that was deductible, based on the average underpaid salaries for previous years plus the actual fixed salary, and a $2 million bonus that was determined reasonable for the year at issue. Regarding the Section 6662(a) accuracy-related penalty, the court noted that Aries did not provide any evidence of reasonable cause; accordingly, the penalty was upheld.

If this case had been decided exclusively under the independent investor test, which many courts, including the courts in *Menard*, *Multi-Pak*, *Mulcahy*, and *Thousand Oaks*, have more recently favored, it would appear that a different result would have been reached and all of the compensation would have been treated as reasonable compensation. Additionally, in applying the independent investor test, courts are finding that a rate of return between 10% to 20% is a reasonable return for the independent hypothetical investor. Finally, applying the independent investor test to personal service corporations as the court did in *Mulcahy*, gives the IRS another weapon (in addition to compensatory intent) to attack the reasonableness of compensation paid by personal service corporations to their shareholder-employees.

UNREASONABLY LOW COMPENSATION AND S CORPORATIONS

Because the Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes may be substantial, many shareholder-employees of S corporations have employed a strategy of decreasing the amount of wages they receive from the S corporation and correspondingly increasing the amount of S corporation distributions made to them. One of the major advantages of operating as an S corporation rather than as a partnership (or LLC taxed as a partnership) is the ability to limit Social Security taxes or at least to have some clarity as to when and how Social Security taxes apply (as opposed to LLCs where the application of the self-employment tax to the members of an LLC is unclear at best.)

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.

Social Security Taxes on Wages

As part of FICA, a tax is imposed on employees and employers up to a prescribed maximum amount of employee wages. This tax is comprised of two parts, the Old-Age, Survivor, and Disability Insurance (OASDI) portion and the Medicare Hospital Insurance (HI) portion. The HI tax rate

is 1.45% on both the employer and the employee, and the OASDI tax rate is 6.2% on both the employer and the employee. The maximum wages subject to the OASDI tax rate for 2015 is $118,500.

The Revenue Reconciliation Act of 1993[9] repealed the dollar limit on wages and self-employment income subject to the HI portion of the FICA tax as well as the self-employment tax. Thus, employers and employees will equally be subject to the 1.45% HI tax on *all* wages, and self-employed individuals will be subject to the 2.9% HI tax on *all* self-employment income.

Health Care and Education Reconciliation Act of 2010

The Health Care and Education Reconciliation Act of 2010,[10] imposes a new tax on unearned income on individuals, partners of partnerships, members of LLCs taxed as partnerships, and S corporation shareholders. Specifically, Section 1411(a)(1) imposes a 3.8% tax on the lesser of (1) "net investment income" or (2) the excess of modified adjusted gross income over $250,000 in the case of taxpayers filing a joint return and over $200,000 for other taxpayers. Under Section 1411(c)(A)(i), "net investment income" includes gross income from interest, dividends, annuities, royalties, and rents other than such income which is derived in the ordinary course of a trade or business. Consequently, items of interest, dividends, annuities, royalties, and rents of an individual or which pass through a partnership, LLC, or S corporation to its partners, members, or shareholders, will retain their character as net investment income and will be subject to the new 3.8% tax on net investment income.

Additionally, the term "net investment income" includes: (1) any other gross income derived from a trade or business if such trade or business is a passive activity within the meaning of Section 469, with respect to the taxpayer; and (2) any net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business that is not a passive activity under Section 469 with respect to the taxpayer.

The Health Care and Education Reconciliation Act of 2010 also increased the Medicare portion of the FICA tax by .9% (to 3.8%) on wages in excess of $250,000 in the case of taxpayers filing a joint return and more than $200,000 for other taxpayers, as well as the Medicare portion of the self-employment tax by .9% (to 3.8%) on earnings from self-employment in excess of $250,000 in the case of taxpayers filing a joint return and more than $200,000 for other taxpayers.

These new tax provisions are effective for tax years beginning after 1/31/12.

Social Security Taxes and S Corporations

In order for shareholder-employees 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 purposes or as net earnings from self-employment (NESE) for purposes of the self-employment tax. For FICA and FUTA purposes, Sections 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.

It might appear at first glance that a shareholder's distributive share of income from an S corporation constitutes NESE since a general partner's distributive share of the income of any trade or business carried on by a partnership of which he or she is a member generally constitutes NESE subject to the self-employment tax. However, in Rev. Rul. 59-221,[11] the IRS found that an S corporation's income does not constitute NESE for purposes of the self-employment tax. Additionally, Section 1402(a)(2) specifically excludes from the definition of NESE dividends on shares of stock issued by a corporation.

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 NESE subject to the self-employment tax. In Rev. Rul. 66-327,[12] the IRS 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 under Section 172(c). Similarly in Ltr. Rul. 8716060, the IRS concluded that the income derived by a shareholder-employee from an S corporation did not constitute NESE 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.

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. Prior to advising an S corporation with shareholder-employees to undertake such a tax planning strategy, however, the tax practitioner should analyze the economic and tax consequences that such a strategy will have on the S corporation and its shareholders.[13]

Although the amount of funds available for distribution to an S corporation's shareholder-employees will

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9 P.L. 103-66, 8/10/93.

10 P.L. 111-152. 3/30/10.

11 1959-1 CB.225.

12 1966-2 CB 357.

13 See generally, Looney and Levitt, "Reasonable Compensation Issues for Closely-Held and Service Companies," 61st N.Y.U. Ann. Inst. Fed. Tax'n 16 (2003); Looney and Comiter, "Reasonable Compensation: Dividends vs. Wages—A Reverse in Positions," 7 J. Partnership Tax'n 364 (Winter 1991); Clements and 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); and Spradling, "Are S Corp. Distributions Wages Subject to Withholding?" 71 JTAX 104 (1989).

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 under Section 1361(b)(1)(D). Thus, if an S corporation that has both shareholders who are employees and shareholders who are not employees, adopts a tax strategy to reduce Social Security taxes by minimizing wages and maximizing distributions, the increase in the amount of distributions received by the shareholders who are employees will be less than the amount by which their wages were reduced (since distributions must also be made to the shareholders who are not employees). Additionally, 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 based on earnings. Decreasing the amount of wages paid to shareholder-employees of S corporations also will reduce the contribution base for contributions to the corporation's qualified plans.

Reclassification Risks

The following cases and rulings deal with risk of reclassification when salaries paid S corporation shareholder/employees are unreasonably low.

Rev. Rul. 74-44. In Rev. Rul. 74-44, 1974-1 CB 287, two shareholders of an S corporation withdrew *no salary* from the corporation and arranged for the corporation to pay them dividends equal to the amount 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 under FICA and FUTA (which includes all remuneration for employment), the IRS found that the dividends paid to the shareholders constituted wages for FICA and FUTA purposes. Rev. Rul. 74-44, however, did not address the issue of what constitutes reasonable compensation in the S corporation context because 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, Rev. Rul. 74-44 clearly indicates that the payment of *no* compensation will be unreasonable when shareholder-employees provide substantial services to the corporation.[14]

Radtke, Spicer Accounting,* and *Esser. In *Joseph Radtke, S.C.*, 895 F.2d 1196, 65 AFTR2d 90-1155 (CA-7, 1990), the Seventh Circuit recharacterized distributions made to the sole shareholder (an attorney) of an S corporation (a law firm) as wages subject to FICA and FUTA taxes, when the shareholder 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 tax year. The court relied on a broad definition of wages for FICA and FUTA purposes as all remuneration for employment, and concluded that the dividend payments were remuneration for services performed by the shareholder for the S corporation. Likewise, in *Spicer Accounting, Inc.*, 918 F.2d 90, 66 AFTR2d 90-5806 (CA-9, 1990), the Ninth Circuit recharacterized dividend distributions made to a shareholder (an accountant) of an S corporation (an accounting firm) as wages subject to FICA and FUTA taxes when the shareholder received no salary during the tax year. Additionally, in *Fred R. Esser, P.C.*, 750 F. Supp. 421 (DC Ariz., 1990), a district court recharacterized amounts received by the sole shareholder, officer, and director of a legal services S corporation, as wages subject to FICA and FUTA taxes, rather than as distributions. As in *Radtke* and *Spicer Accounting*, the shareholder received no salary from the S corporation during the tax year.

Cave. In *Donald G. Cave, A Professional Law Corp.*, 476 Fed. Appx. 424, 109 AFTR2d 2012-1504 (CA-5, 2012), *aff'g* TCM 2011-48, the Fifth Circuit held that all of the non-shareholder attorneys, as well as a law clerk, of a law firm were common law employees rather than independent contractors. It also recharacterized the distributions made to the sole shareholder of the law firm, who was determined to be a statutory employee, as wages subject to Social Security taxes.

Watson. In *David E. Watson P.C.*, 668 F.3d 1008, 109 AFTR2d 2012-1059 (CA-8, 2012), *aff'g* 757 F. Supp. 2d 877, 107 AFTR2d 2011-311 (DC Iowa, 2010), the Eighth Circuit affirmed the decision of a district court recharacterizing a significant portion of dividend distributions made by an S corporation to its sole shareholder as wages subject to Social Security taxes. During the years in issue, 2002 and 2003, David Watson (Watson), provided accounting services to a partnership (LWBJ) and its clients as an employee of David E. Watson P.C., an S corporation. The S corporation was a 25% partner in LWBJ. The IRS made assessments against Watson after it determined that portions of the dividend distributions from the S corporation to Watson should be recharacterized as wages subject to employment taxes. Specifically, the IRS contended that $130,730 out of a total of $203,651 of dividend payments to Watson for 2002 and $175,470 out of a total of $203,651 of dividend payments to Watson for 2003 should be recharacterized as wages subject to employment taxes. In both years, Watson received a salary of $24,000 in addition to the dividend distributions.

In his summary judgment motion, Watson argued that the S corporation's intent was controlling in determining the characterization of the payments from the S corporation to Watson. Because the S corporation clearly intended to pay Watson compensation of only $24,000 per year, Watson contended that any amounts distributed in excess of the $24,000

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14 See also Rev. Rul. 71-86, 1971-1 CB 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 CB 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. Rul. 7949022 (shareholder-employees of S corporation who perform substantial services for S corporation treated as "employees" for employment tax purposes).

were properly classified as dividends. In support of his position, Watson cited *Electric & Neon, Inc.*, 56 TC 1324 (1971); *Paula Construction Co.*, 58 TC 1055 (1972), and *Pediatric Surgical Associates, P.C.*, TCM 2001-81.

Citing Rev. Rul. 74-44, *Radtke*, *Spicer Accounting* and *Veterinary Surgical Consultants, P.C.*, 117 TC 14 (2001), *aff'd sub nom Yeagle Drywall Co. Inc.*, 54 Fed. Appx. 100, 90 AFTR2d 2001-7744 (CA-2, 2002), the district court found that the intent of the S corporation was not controlling in determining the character of the payments, but rather that the analysis turns on whether the payments at issue were made as remuneration for services performed. Consequently, the court denied Watson's summary judgment motion because it found that there was a genuine issue of material fact as to whether the dividends paid to Watson by the S corporation were remuneration for services performed subject to employment taxes.

Rev. Rul. 74-44 clearly indicates that the payment of *no* compensation will be unreasonable when shareholder-employees provide substantial services to the corporation.

After denying the taxpayer's motion, the district court held a bench trial on the merits. At trial, the government's expert opined that the market value of Watson's accounting services was approximately $91,044 per year for 2002 and 2003. The government's expert was a general engineer with the IRS and had worked on approximately 20 to 30 cases involving reasonable compensation issues. In forming his opinion as to Watson's salary, the government's expert relied on several compensation surveys and studies particularly relating to accountants. The district court ultimately adopted the government expert witness's opinion and determined that the reasonable amount of Watson's remuneration for services performed totaled $91,044 for each of 2002 and 2003.

In addition to determining the issues of what constituted reasonable compensation to the S corporation's sole shareholder and whether intent was the determinative factor in determining whether payments from an S corporation to its sole shareholder should be characterized as wages or as dividend distributions, the Eighth Circuit addressed the taxpayer's argument that the district court erred in allowing the government's expert to testify on the issue of reasonable compensation, because he was not competent to testify on that issue. Specifically, the taxpayer asserted that the government's expert witness was not qualified, changed his opinion, relied on insufficient underlying facts, and used flawed methods in rendering his opinion. After reviewing all of these factors in detail, the appellate court determined that the district court did not abuse its discretion in admitting the testimony of the government's expert witness, and found the taxpayer's arguments meritless.

In reaching its decision, the Eighth Circuit cited Rev. Rul. 74-44, *Radtke*, *Spicer Accounting*, and *Veterinary Surgical Consultants*, concluding that the district court properly determined that the characterization of funds disbursed by an S corporation to its shareholders turns on an analysis of whether the payments at issue were made as remuneration for services performed. The court went on to state that the district court found that the S corporation understated wage payments to its sole shareholder by $67,044 in each year based on a variety of factors. These factors included the following:

1. Watson was an exceedingly qualified accountant with an advanced degree and nearly 20 years in accounting and taxation.
2. Watson worked 35-45 hours per week as one of the primary earners in a reputable firm, which had earnings much greater than comparable firms.
3. The partnership had gross earnings of more than $2 million in 2002 and nearly $3 million in 2003.
4. Compared to other similarly situated accountants, $24,000 is an unreasonably low salary.
5. Given the financial position of the partnership, Watson's experience, and his contributions to the partnership, a $24,000 salary was exceedingly low when compared to the roughly $200,000 the partnership distributed to Watson's S corporation in 2002 and 2003.
6. The fair market value of Watson's services was $91,034.

The Eighth Circuit next addressed the taxpayer's argument that, instead of focusing on reasonableness, the district court should have focused on the S corporation's intent. While acknowledging that Section 162(a)(1) provides that the deductibility of compensation is a two-prong test in that the compensation must both be reasonable in amount and in fact payments purely for services, the court, citing *Elliotts*, stated that courts usually need to examine only the first prong since the reasonableness prong generally subsumes the inquiry into compensatory intent in most cases. The court did state however, that, in certain rare cases, whether there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness.

The taxpayer cited *Pediatric Surgical Associates* in support of his position that taxpayer intent controls in FICA tax characterization cases. The Eighth Circuit found that even if intent does control, after evaluating all the evidence, the district court specifically found that the shareholder's assertion that the S corporation intended to pay him a salary of only $24,000 a year was less than credible. Additionally, the Eighth Circuit went on to reject the taxpayer's argument that *Pe-*

diatric Surgical Associates limited the amount that could be characterized as wages to the amount of revenue each shareholder-employee personally generated, less expenses since, like *Pediatric Surgical Associates,* nonshareholder-employees also contributed to the S corporation's earnings. The Eighth Circuit brushed this argument aside by saying that although it thought evidence of shareholder-employee billings and collections may be probative on the issue of compensation, in light of all the evidence presented to the district court in the case, it saw no error and affirmed the decision of the district court.

Herbert. In *Herbert,* TC Summary Opinion 2012-124, the Tax Court recharacterized a portion of the amounts the taxpayer claimed were used to pay business expenses as wages subject to Social Security taxes, finding the taxpayer's salary was unreasonably low. However, the Tax Court expressly rejected the IRS's contention that the taxpayer's salary be increased by $52,600, primarily based on the salary paid by the S corporation to the shareholder in a prior year in which the business was not owned by the taxpayer.

In reaching this decision, the Tax Court believed and accepted the taxpayer's testimony that the taxpayer in fact paid significant expenses of the corporation with cash funds received from the corporation. Additionally, the court found that despite limited evidence before them, they believed that it was improper and excessive to charge the taxpayer with receipt of $52,600 in additional wages from the corporation in 2007. On the other hand, the court stated that the taxpayer's reported wages of $2,400 was unreasonably low.

Consequently, citing *Mayson Manufacturing Co.*, 178 F.2d 115, 38 AFTR 1028 (CA-6, 1949). the Tax Court averaged the taxpayer's wages for 2002 through 2006, and used the average amount as the total for the taxpayer's 2007 wages subject to employment taxes ($30,445).

McAlary. In *Sean McAlary Ltd., Inc.*, TC Summary Opinion 2013-62, the Tax Court recharacterized the distributions made by an S corporation to its sole shareholder as wages subject to Social Security taxes when the shareholder received no salary from the S corporation. The court also found that the annual compensation formula contained in the board of directors minutes setting a salary of $24,000 was unreasonably low.

Mr. McAlary was the president, secretary, treasurer, sole director, and sole shareholder of his S corporation. He managed all aspects of the S corporation's operations, including recruiting and supervising sales agents, conducting real estate sales, procuring advertising, purchasing supplies, and maintaining basic books and records. Mr. McAlary often worked 12-hour days with few days off. For the year in issue, Mr. McAlary supervised eight sales agents, four of whom generated sales commissions for the S corporation that year; however, most of the S corporation's gross receipts were attributable to sales commissions generated by Mr. McAlary himself.

For the year in issue, the S corporation did not issue a form W-2 to Mr. McAlary, nor did it claim a deduction for the amount paid to him as wages or compensation for services. During that year, Mr. McAlary transferred a total of $240,000 from the S corporation's account to his personal account.

In determining what portion of the $240,000 of distributions should be recharacterized as wages, the IRS's expert witness found that $100,755 represented reasonable compensation for services rendered by Mr. McAlary for the year in issue. On the other hand, Mr. McAlary argued that even though he did not pay himself a salary, the $24,000 salary set forth in the compensation arrangement in the corporation's minutes should be the only amount characterized as wages subject to Social Security taxes.

The Tax Court, citing the multi-factor test used in determining reasonable compensation for shareholder employees of C corporations, found that reasonable compensation for Mr. McAlary's services during the year in issue was $83,200, and as such, recharacterized $83,200 of the $240,000 distributed by the S corporation to Mr. McAlary as wages subject to Social Security taxes.

Glass Blocks. In *Glass Blocks Unlimited*, TCM 2013-180, the Tax Court recharacterized the total distributions of $30,844 in 2007 and $31,644 in 2008, which were made by an S corporation to its president, sole shareholder, and only full-time employee as wages subject to Social Security taxes.

Citing *Veterinary Surgical Consultants P.C.*, the court said that an officer who performs more than minor services for a corporation and receives remuneration in any form for those services is considered an employee, and his or her wages are subject to the employer's payment of federal employment taxes. The court went on to find that the taxpayer was the S corporation's only officer, and sole full-time worker in 2007 and 2008, performing substantially all the work necessary to operate the business.

Citing the multi-factor test used in *Elliotts,* the court rejected the taxpayer's arguments that the distributions constituted repayment of shareholder loans and that the characterization of all distributions from the S corporation to him as wages constituted unreasonably high compensation to him. Consequently, the Tax Court found that the total amount of distributions made by the S corporation to its sole shareholder constituted wages subject to Social Security taxes for the years in issue.

Abusive vs. non-abusive situations. The Herbert, Watson and McAlary cases involve situations in which only a portion of amounts not treated as wages are recharacterized as wages subject to Social Security taxes, and each involves different methods in determining what constitutes "reasonable compensation" to the shareholder-employees of an S corporation.

Watson, *Herbert*, and *McAlary* are the first reported decisions in which the court was presented with a situation that was not clearly abusive, such as those presented in *Radtke* and *Spicer Accounting* (i.e., in which *all* of the earnings of the S corporations were paid

to the sole shareholder as dividend distributions and no salary was paid to the shareholder by the S corporation). Consequently, *Watson, Herbert,* and *McAlary* represent important victories for the IRS's ability to recharacterize dividend distributions as wages when at least some (but less than a reasonable) salary has been paid to the shareholder-employees of the S corporation. On the other hand, these cases can be viewed as favorable to taxpayers as they allowed personal service S corporations to distribute a good portion of their income without being subject to Social Security taxes. However, somewhat troubling is *Watson's* rejection of the *Pediatric Surgical Associates, P.C.* case (in which the IRS sought to recharacterize wages of a C corporation as dividend distributions rather than vice versa). The court did not seem to take into account the fact that dividend distributions can indeed be generated by the services of nonshareholder-employees of an S corporation or from other ancillary services not provided by the shareholder-employees of the S corporation.

Radtke, Spicer Accounting, and *Esser* indicate that in abusive situations, such as when S corporation shareholders make all withdrawals from the S corporation in the form of S corporation distributions and receive no salary from the S corporation during the tax year, the courts will recharacterize such distributions as wages subject to Social Security taxes. These earlier cases have been followed by more recent cases.[15]

In non-abusive situations, however, the IRS 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 order for the IRS to do this, it would have to overcome: (1) the lack of express authority for its position (unlike the express authority granted to the IRS under Section 1366(e) to recharacterize dividend distributions as wages in the family context); (2) the burden of overcoming the initial characterization of the payment as a distribution; and (3) the uncertainty surrounding the use of Section 162(a)(1) by the IRS in the employment context to bring salaries *up* to a reasonable level.

Obviously, the key is determining what is an abusive situation versus what is a non-abusive situation regarding reasonable compensation in the S corporation context. In IRS Fact Sheet 2008-25 (August, 2012), the IRS provides that although there is no "bright line" test for determining what constitutes "reasonable compensation" to S corporation shareholder-employees, a multi-factor type analysis similar to the factors set forth in *Mayson Manufacturing Co.* should be used. In *Herbert*, the court expressly stated that it was applying a multi-factor test to determine reasonable compensation, but actually used an average salary approach in determining the reasonable compensation of the shareholder-employee. The court in *Watson* relied on expert witness testimony as to the reasonableness of compensation, and in *McAlary* and *Glass Blocks*, the court said that the multi-factor test was being used to determine the reasonableness of compensation without going into an in-depth analysis of those factors in such cases. In any event, it would seem inappropriate to apply the independent investor test to determine the reasonableness of compensation in the S corporation context, as that would result in all of the amounts being received by the shareholder-employees of an S corporation being characterized as wages other than the amounts determined to be a reasonable rate of return payable to the hypothetical independent investor.

Consequently, in non-abusive situations, a tax strategy of decreasing wages and correspondingly increasing distributions to shareholder-employees could result in substantial employment tax savings. As a result of this tax planning technique, the IRS, the Joint Committee on Taxation, the Department of Treasury, and Congress have issued reports and notices, and have introduced legislation over the last 10-15 years in an attempt to impose the self-employment tax on the earnings of certain S corporations to one degree or another.

Recent Attempts to Subject S Corporations to Self-Employment Tax

On 10/19/06, the Senate Finance Committee released a report entitled "Additional Options to Improve Tax Compliance," that was prepared by the members of the Joint Committee on Taxation. The report addressed, among other things, a proposal that would generally treat service partnerships, LLCs, and S corporations the same for self-employment tax purposes, so that partners', members', or shareholders' distributive shares of income from a service entity would be subject to the self-employment tax. In reaction to this controversial and politically charged report, the Partnerships and LLCs Committee and the S Corporations Committee of the American Bar Association Tax Section published comments, which included, among other things, a statement that the rules currently in effect for S corporations in determining reasonable compensation subject to Social Security taxes were correct and should not be changed.

On 1/15/10, the U.S. Government Accountability Office (GAO) released a report entitled "Tax Gap: Actions Needed to Address Noncompliance With S Corporation Tax Rules."[16] Although the purported purpose of the GAO study was to look at compliance challenges for S corporations and their shareholders, the study appears, at least in part, to take the position that the self-employment tax should be imposed on some or all of the in-

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[15] See *Veterinary Surgical Consultants, P.C.*, 117 TC 14 (2001), *aff'd sub nom Yeagle Drywall Co. Inc.*, 54 Fed. Appx. 100, 90 AFTR2d 2001-7744 (CA-2, 2002), *Van Camp & Brennion*, 251 F.3d 862, 87 AFTR2d 2001-2408 (CA-9, 2001), *Old Raleigh Realty Corp.*, TC Summary Opinion 2002-61, *David E. Watson P.C.*, 668 F.3d 1008, 109 AFTR2d 2012-1059 (CA-8, 2012), *aff'g* 757 F. Supp. 2d 877, 107 AFTR2d 2011-311 (DC Iowa, 2010), *Herbert*, TC Summary Opinion 2012-124, *Sean McAlary Ltd., Inc.*, TC Summary Opinion 2013-62, and *Glass Blocks Unlimited*, TCM 2013-180.

[16] GAO 10-195, 12/15/09.

come of S corporations (and in particular, S corporations that are service corporations).[17]

Section 413 of the American Jobs and Closing Tax Loopholes Act of 2010[18] would have added new Section 1402(m) to subject certain S corporation shareholders to the self-employment tax imposed under Section 1402 on their distributive share of the income of an S corporation. The S corporations targeted by Section 1402(m) were basically S corporations having three or fewer shareholders engaged in professional service businesses. Although this provision was not ultimately enacted into law, this concept of subjecting an S corporation's distributive share of income to the self-employment tax has been reincarnated a number of times with slight variations. For example, a provision similar to Section 1402(m) was introduced by Representative Pete Stark on 12/31/12 in a bill entitled "The Narrowing Exceptions for Withholding Taxes" (NEWT Act), in reaction to the release of Newt Gingrich's tax returns.[19] A similar provision was found in the original version of the Stop Student Loan Interest Rate Hike of 2012.[20] Representative Rangel reintroduced the NEWT Act on 1/22/13, and a copy of a list of "tax breaks" that the Democrats were targeting as part of the Joint Conference Committee on the Budget highlighted the so-called "S corp loophole," which the Budget Committee stated "is a loophole … that allows certain wealthy professionals to avoid paying payroll taxes on their earnings."[21] Similarly, in a report dated 7/31/14, the Citizens for Tax Justice approved adoption of the provision in President Obama's most recent budget plan, which generally imposes the self-employment tax on all businesses providing professional services, whether structured as S corporations, partnerships, or LLCs.

Most recently, a disturbing proposal came from an unlikely source: the former Chairman of the House Ways and Means Committee, Representative Dave Camp. In Representative Camp's discussion draft released on 2/26/14 (referred to as the "Tax Reform Act of 2014," or more commonly as the "Camp Proposal"), the self-employment tax is imposed on S corporation shareholders who materially participate in their businesses within the meaning of Section 469. The Camp Proposal generally subjects 70% of the combined compensation and distributive share of an S corporation's (or partnership's) income as net earnings from self-employment subject to FICA or SECA, as applicable.

The authors believe that Representative Camp's proposal would have a crippling effect on many small businesses that use pass-through entities (which overwhelmingly outnumber C corporations), and gives no credit whatsoever to the large capital investment many of these pass-through entities, such as those in the manufacturing sector, have made in their businesses. Representative Camp's proposal on this issue is completely arbitrary and totally inequitable to pass-through entities, especially S corporations, which have been formed with increasing frequency in recent years by taxpayers to conduct their businesses in reliance on the rules currently in effect regarding application of FICA and SECA to S corporations and their shareholders.

Application of Social Security Taxes and Net Investment Income Tax to S Corporations

A number of commentators have recently made potentially negative comments regarding non-wage distributions from "personal service" S corporations being one of the few paths to receive income untouched by the FICA tax, self-employment tax, or new net investment income (NII) tax.[22] First of all, it is important to recognize that non-wage distributions from a non-personal service corporation, such as a manufacturing company, are also not subject to these taxes (including the NII tax if the shareholder materially participates in the business). It is also important to recognize that with respect to personal service S corporations, the IRS and the courts can and have recharacterized nonwage distributions as "wages" subject to the FICA tax when unreasonably low compensation is being paid to the S corporation shareholders, so that personal service S corporations may not "avoid" the FICA tax on amounts distributed as dividends if they are in substance wages (see *Radtke, Spicer Accounting*, and *Watson*).

Additionally, both the IRS and the courts expressly recognize that a so-called personal service corporation may indeed produce earnings that are properly characterized as dividend distributions rather than wages (see the recent *Mulcahy* case, as well as the *Pediatric Surgical Associates, P.C.* and *Richlands Medical Association* cases). Quite simply, the FICA and self-employment taxes were meant to apply only to wages of an individual for personal services he or she actually renders, and not to active operating income (profits) of a business paid out as dividend distributions to shareholders. On the other hand, the NII tax was meant to subject certain higher income taxpayers to the 3.8% tax on passive type investment income, not to the profits of a business in which they materially participate. Consequently, any suggestion that the use of S corporations to "avoid" these three taxes is abusive simply misses the mark because entrepreneurial profits of a business not attributable to wages paid for personal services actually rendered by a shareholder were never intended to be subject to any of these three taxes.

Several comments were also made that the NII tax would probably not cause taxpayers to change

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[17] For a critique of the GAO Report, see Looney and Levitt, "Practitioners Respond to GAO Report on S Corporations," 126 Tax Notes 992 (2/22/10).

[18] H.R. 4213.

[19] See "Shades of John Edwards in Gingrich Return," 2012 TNT 15-2 (1/24/12), and "Stark Introduces Bill to Remove Self-Employment 'Tax Dodge'," 2012 TNT 21-37 (1/31/12).

[20] S. 2343 which was originally proposed by Senate Majority Leader Harry Reid on 4/24/2012.

[21] See "Democrats List Targets for Elimination in Budget Talks," 2013 TNT 217-1 (11/8/13).

[22] See Trivedi, Coder, and Arora, "Practitioners Busy With Net Investment Income Tax Regs," Tax Notes, 12/10/12, p. 1149, Doc 2012-25152, 2012 TNT 234-1.

their business structures to S corporations. The fact is, according to recently published IRS statistics, the number of entities filing S corporation returns already exceeds the number of entities filing returns as partnerships, and the IRS projects that the gap in the number of entities filing as S corporations versus partnerships will continue to grow in the future.[23] Consequently, S corporations are already one of the most popular types of structures for small businesses, and the new tax on NII should reinforce that.

Finally, although it may be possible for an LLC member or limited partner to materially participate so that his or her distributive share of income would not be subject to the NII tax, that would likely result in that member's or partner's distributive share of the income of the LLC or partnership being subject to the self-employment tax,[24] including the increased 3.8% Medicare tax imposed on the self-employment income of higher income taxpayers. The correct answer here does not have so much to do with defining what a limited partner is for self-employment or NII tax purposes, but rather to apply the test used in the S corporation area, a reasonable compensation test, to LLCs and partnerships.

UNREASONABLY HIGH COMPENSATION AND S CORPORATIONS

One area in which an S corporation could potentially face a challenge by the IRS for unreasonably high compensation relates to the "taxable income" limitation under the built-in gain tax imposed by Section 1374. Because the base of the built-in gain tax is limited to a corporation's taxable income, one method of avoiding the built-in gain tax would be to zero out the corporation's taxable income[25] for the entire ten-year built-in gain period. Such a strategy seems inadvisable in that it could very well subject the S corporation to the same unreasonable compensation arguments to which it would have been subject had it remained a C corporation. An S corporation would be susceptible to an unreasonable compensation argument in this context since the result of recharacterizing amounts paid as compensation to the shareholder-employees as distributions would be to increase the corporation's taxable income above zero, and thus, subject it to the built-in gain tax.[26]

CONCLUSION

Shareholders of C corporations will continue to face compensation reclassification risks based on traditional unreasonably high compensation arguments by the IRS in order for the IRS to recharacterize a portion of the wages paid to the shareholder-employees of the C corporation as dividends subject to double taxation. Although the courts have traditionally applied a multi-factor test in determining the reasonableness of compensation, they have more recently relied on application of the independent investor test to determine the reasonableness of compensation in the C corporation setting. Additionally, although it has been widely accepted in the past by practitioners and taxpayers that the IRS cannot successfully assert unreasonable compensation arguments against personal service corporations to recharacterize a portion of the compensation paid to the corporation's shareholder-employees as dividend distributions, in light of the application of the independent investor test by the Tax Court and the Seventh Circuit in *Mulcahy* as well as the Tax Court's prior use of the compensatory intent test in *Pediatric Surgical Associates, P.C.*, tax practitioners must recognize that the IRS can make a successful argument to recharacterize wages paid to the shareholder-employees of personal service corporations as dividends subject to double taxation.

On the other hand, S corporation shareholder-employees will continue to face compensation reclassification risks based on the IRS asserting that the compensation being paid to the shareholder-employees is unreasonably low so that all or a portion of the amounts distributed to the shareholder-employees as dividend distributions should be recharacterized as wages subject to Social Security taxes. While taxpayers generally have lost in situations that are clearly abusive such as when the shareholder-employee withdraws all of the funds from the S corporation as dividend distributions and takes no salary, more recent cases demonstrate that as long as a reasonable amount of compensation (usually based on the multi-factor test) is paid to S corporation shareholder-employees, the remaining amounts may be distributed as dividends that are not subject to Social Security taxes. ●

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23 See, Document 6292, Office of Research, Analysis and Statistics, Fiscal Year Return Projections for the United States: 2013-2021, Rev. 6/14.

24 See, e.g., *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137 (2011), *Howell*, TCM 2012-303, *Riether*, 919 F. Supp. 2d 1140, 112 AFTR2d 2013-6074 (DC N.M., 2012), and CCA 201436049, in which the courts and the IRS have basically treated LLC members that provide significant services on behalf of the LLCs as general partners rather than limited partners under Section 1402(a)(13) so that such members were *not* allowed to exclude their distributive share of LLC income from self-employment tax.

25 Section 1374(d)(2)(A)(ii).

26 An alternative (and better) method of avoiding the built-in gain on the accounts receivable of a cash basis taxpayer is to accrue bonuses (in an amount equal to its receivables) to its shareholder-employees in its last tax year as a C corporation and pay such bonuses to its shareholder-employees in the first two and one-half months of its first tax year as an S corporation. Ltr. Rul. 200925005 confirms that this strategy should work to eliminate the built-in gain tax attributable to the accounts receivable of a cash basis taxpayer. Another method of avoiding forced double taxation on its receivables, is for the cash basis service corporation converting to S corporation status to accelerate its receivable income and recognize such income prior to conversion to S corporation status. See generally, Looney & Levitt, "Reasonable Compensation Issues for Closely-Held and Service Companies," 61st N.Y.U. Ann. Inst. Fed. Tax'n 16 (2003).