

# Court advances IRS case against S corporation for underpaying employment taxes

## Watson v. U.S., (DC IA 05/27/2010) 105 AFTR 2d 2010-908

In a recent district court case in which IRS claimed that a portion of the dividend distributions by an S corporation to its sole owner should be recharacterized as wages subject to employment taxes, the court rejected the corporation's assertion that IRS could not compel the corporation to pay a higher salary to the owner. Accordingly, the court would not order IRS to refund employment taxes paid by the corporation after IRS made the assessment. Rather, it allowed the case to proceed.

**RIA observation:** This is a hot subject as the American Jobs, Closing Tax Loopholes and Preventing Outsourcing Act of 2010, which passed the House on May 28, 2010, contains a provision that would clamp down on certain service professionals who try to minimize Medicare and Social Security taxes by routing their self-employment income through an S corporation and then pay themselves a nominal salary (see Weekly Alert 11 2 06/03/2010 ).

*Facts.* In '92, David E. Watson joined with Tom Larson, Jeff Bartling, and Dale Eastman to form an accounting firm named Larson, Watson, Bartling & Eastman ("LWBE"). On Oct. 11, '96, Watson incorporated David E. Watson, P.O (DEWPC) as an Iowa Professional Corporation (PC). Larson, Bartling, and Eastman also formed PCs, and on Oct. 11, '96, each of the four partners replaced their individual ownership in LWBE with ownership by their respective PC. On the same date, LWBE, DEWPC, and Watson entered into an employment agreement whereby Watson became DEWPC's employee and agreed to provide his accounting services exclusively to LWBE.

By '98, Paul Jeffer, PC, had replaced Dale Eastman, PC as a partner, causing LWBE to be reformed as Larson, Watson, Bartling, and Jeffer ("LWBJ"). The change did not significantly alter the work performed by the firm, or the employment arrangement between the firm, DEWPC, and Watson.

During 2002 and 2003 (the years at issue), Watson provided accounting services exclusively to LWBJ and its clients as an employee of DEWPC. Under the arrangement between Watson, DEWPC, and LWBJ, LWBJ provided professional liability insurance for Watson and had the authority to determine how much vacation Watson could take. From 2002 to 2003, and continuing to the present, LWBJ's website listed Watson, rather than DEWPC, as a partner, and Watson held himself out to the public as a specialist in partnership taxation

Since its inception, DEWPC had elected to be taxed as an S Corporation, and Watson had been its sole shareholder, employee, director, and officer. Watson was the only person to whom DEWPC distributed money in 2002 or 2003. At shareholder meetings Watson held with himself in 2000-2002, he authorized for himself a salary from DEWPC in the amount of \$24,000 annually. In selecting his salary, Watson did no research other than to talk to Larson, Bartling and Jeffer to reach an agreement on what salary each would pay himself. In 2002 and 2003, DEWPC paid Watson \$24,000 in funds designated as salary and paid federal employment taxes on that amount.

In 2002, in addition to his \$24,000, Watson received checks from DEWPC totaling \$203,651, \$118,159 of which were recorded as dividend distributions. In 2003, in addition to his salary, Watson received \$221,577 in dividend payments from DEWPC. In both years, Watson worked for DEWPC an average of 35 to 45 hours per week for about 46 weeks per year. For both years, his monthly living expenses exceeded his \$2,000 monthly salary.

On Feb. 5, 2007, IRS assessed \$48,519 in taxes, penalties, and interest against DEWPC for the eight calendar quarters of 2002 and 2003. It made these assessments after it determined that portions of the dividend distributions from DEWPC to Watson should be recharacterized as wages paid to Watson, subject to employment taxes under Code Sec. 3101 and Code Sec. 3111 . Specifically, IRS contended that \$130,730 of the dividend payments to Watson for 2002 and \$175,470.00 of the dividend payments to Watson for 2003 should be recharacterized as wages subject to employment taxes. DEWPC later paid \$4,063.93 toward these assessments and then filed a claim for refund for the payment. IRS denied the claim and DEWPC sued in district court.

*Background.* S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. S shareholders report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. ( Code Sec. 1366 )

Code Sec. 3111 imposes FICA (social security) taxes on employers for wages paid to their employees.

Fact Sheet 2008-25, August 2008 warns S corporations not to attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages. The instructions to the Form 1120S, U.S. Income Tax Return for an S Corporation, state "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

Fact Sheet 2008-25, August 2008 lists these factors that courts have considered in determining reasonable compensation.

- training and experience;
- duties and responsibilities;
- time and effort devoted to the business;
- dividend history;
- payments to non-shareholder employees;
- timing and manner of paying bonuses to key people;
- what comparable businesses pay for similar services;
- compensation agreements; and
- use of a formula to determine compensation.

*Court refuses to hold against IRS.* The parties agreed that if the funds paid to Watson are properly characterized as dividends, DEWPC need not pay FICA taxes on them, but that if the funds are properly recharacterized as wages, DEWPC would be required to pay FICA tax.

DEWPC argued that its intent controls whether funds paid to Watson are categorized as wages or as dividends. But the court found that this position was undermined by IRS revenue rulings and case law. For example, in Rev Rul 74-44, 1974-1 CB 287 , IRS concluded that dividends received by an S corporation's two sole shareholders were wages for which the corporation was liable for FICA, FUTA and income tax withholding, and in *Radtke, Joseph v. U.S.*, (1989, DC WI) 63 AFTR 2d 89-1469 affd (1990, CA7) 65 AFTR 2d 90-1155 , a district court determined that certain funds designated as dividends were actually compensation for which an S Corporation owed employment taxes.

Based on these and other authorities, the district court agreed with IRS that DEWPC's self-proclaimed intent to pay Watson \$24,000 in salary does not limit IRS's ability to recharacterize dividends paid to Watson as wages, even though DEWPC properly documented its claimed intent in its corporate records. Rather, the characterization of funds disbursed by an S corporation to its employees or shareholders turns on an analysis of whether the payments were made as remuneration for services performed. Thus, the case will proceed to determine whether the dividends were really remuneration for services performed.

**References:** For S corporation dividends as wages subject to withholding, see FTC 2d/FIN 11 H-4329 ; TaxDesk 532,002 .