Foster Garvey

Larry's Tax Law

A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part VII – Unreasonable Compensation In The S Corporation Setting

By Larry Brant on 6.5.24 | Posted in Internal Revenue Code, Tax Laws, Tax Planning

Overview

In the S corporation arena, tax advisors generally do not focus much attention on unreasonable compensation. As we delve into the issue in this Part VII of my multi-part series on Subchapter S, it will become apparent that reasonableness of compensation in the S corporation setting is important. Failure to pay attention to the issue can place S corporations and their shareholders in peril.

Closely held C corporations have historically been incentivized to distribute profits as compensation to shareholder employees. A corporation is allowed, under IRC § 162(a)(1), to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." There is, however, no corresponding deduction for dividend distributions, which end up being taxed twice: once at the corporate level upon earning the income that funds the dividend, and again at the shareholder level upon receipt of the dividend. Consequently, treating distributions of profits as compensation for services rendered could significantly reduce a corporation's tax liability.

On the other hand, while a corporation may get a deduction under IRC § 162(a)(1) for compensation payments, the shareholder employee receiving the payments ends up with a larger tax bill because the payments are taxed as ordinary income and subject to payroll taxes (e.g., Social Security and Medicare taxes). Had the payments been characterized as dividends, in the case of a C corporation, the shareholder employee would have avoided much of these taxes, paying tax at a federal tax rate on dividends of 23.8 percent.[1]

To compare the two scenarios (dividend distributions vs. compensation payments), we must consider both the corporate and the individual income tax regimes. Corporate profits distributed as compensation are taxed only once because the payments are deductible from the corporation's taxable income under IRC § 162(a)(1). In contrast, as discussed above,

distributions of corporate profits treated as dividends are taxed twice: once at the corporate level and once at the shareholder level.

Usually, in the S corporation context, taxpayers are primarily concerned with making shareholder employee compensation as low as possible to reduce employment and self-employment taxes, both of which include Social Security taxes and the Medicare taxes. The Social Security taxes are imposed on employee compensation and self-employment income up to the Social Security Wage Base (currently $168,600), and the Medicare taxes are imposed on employee compensation and self-employment income without a ceiling. By paying low compensation, S corporations and their shareholder employees can limit their liability for Social Security taxes and Medicare taxes.

However, the law is clear – shareholder employees of S corporations must be paid reasonable compensation for services actually performed for the corporation.[2] The risk of not paying shareholder employee's adequate compensation for services actually rendered is the taxing authority's recharacterization of the distributions as wages. With such a recharacterization comes:

- Penalties;
- Interest;
- Payroll taxes (Social Security and Medicare); and
- Possible loss of the S election.

Despite the reasons for paying low compensation, there are countervailing incentives for some S corporations to pay high compensation. For example, a shareholder employee may wish to maximize his or her retirement contributions, which are based on compensation. In addition, the S corporation could be motivated to pay excessive compensation to one shareholder to avoid violating the single class of stock requirement under Code § 1361(b)(1)(D). Finally, in some cases an S corporation may want to pay excessive compensation to eliminate its income, avoiding paying the built-in gains tax imposed under Code § 1374 or being exposed to the passive investment tax imposed under Code § 1375 as limited by the income of the corporation as a result of Code § 1375(b)(1)(B).

Unreasonably Low Compensation in the S Corporation Setting

Unreasonably low compensation is likely on the Service's S corporation audit list. It is low-hanging fruit.

Tax practitioners need to take action to prevent the Service from asserting that S corporation distributions should be treated as shareholder employee compensation.

PRACTICE ALERT: Advise S corporation clients to consider developing a compensation methodology for shareholder employees that establishes compensation based upon:

- Personal qualifications;
- Nature, extent and scope of work actually performed;
- Compensation required to be deferred in prior years due to lack of available cash;
- Compensation paid for similar work by the corporation to its non-shareholder employees; and
- Compensation paid for similar work in comparable businesses.

Application of the above factors, and the actual compensation derived therefrom, should be documented in written corporate minutes each year.

Cases and Rulings

S corporation employee shareholders could seemingly take earnings without paying employment or self-employment taxes. However, the IRS and the courts have ruled S corporations must at least pay reasonable salaries to employee shareholders, which would be subject to payroll taxes.

Radtke v. United States[3]

Dividends an S corporation pays to its only employee are wages subject to employment taxes

Regardless of how an employer characterizes employee payments, the true analysis is whether the payments represent remuneration for services rendered. In *Radtke v. United States*, the District Court for the Eastern District of Wisconsin held the distributions from an S corporation, a personal service corporation, to its sole shareholder and only employee, an attorney who

worked full-time, were wages subject to employment taxes. The corporation paid the attorney no salary, but declared dividends whenever it had money in the bank. It paid no employment taxes on the dividends. The court explained that an employer cannot evade payroll taxes by characterizing all employee payments as non-wages, and that the situation "is simply the flip side of those instances in which corporations attempt to disguise profit distributions as salaries for whatever tax benefits that may produce." Accordingly, the court held the "dividends" functioned as "remuneration for employment" and thus were subject to employment taxes. The Seventh Circuit agreed.[4] Where compensation is paid as dividends, and no salary is paid, the dividends are reclassified as compensation for services subject to employment tax.[5]

Spicer Accounting, Inc. v. United States[6]

An S corporation must pay its shareholder employees reasonable compensation for services performed for the corporation

In *Spicer Accounting*, the Ninth Circuit denied the taxpayer's claim for a refund of employment taxes paid on amounts the corporation distributed to its shareholder employee, Spicer. Spicer was the president, treasurer and director of the taxpayer, Spicer Accounting, Inc.

Spicer and his wife were shareholders in the taxpayer, each owning a 50% interest. Spicer never signed an employment agreement and was never paid wages from the taxpayer. He reported the taxpayer's distributions as dividend income. Spicer worked for the taxpayer roughly 36 hours a week. He was the taxpayer's only accountant, although his wife and another employee worked as bookkeepers and prepared tax returns. Spicer testified he thought paying compensation as dividends was a correct way to avoid paying employment taxes.

The Service assessed payroll taxes, penalties, and interest for 1981 and 1982. After paying the assessed amounts, the taxpayer filed a refund claim with the Service. Upon denial, he filed suit in the local district court. The district court held Spicer was an employee and his wages were subject to employment taxes. The taxpayer then appealed to the Ninth Circuit.

On appeal, the Ninth Circuit concluded Spicer was an employee and the dividends were wages subject to employment taxes. It explained that, under Treas. Reg. §§ 31.3121(a)1(b), 31.3306(b)-1(b), "an officer who performs substantial services for the corporation is considered an employee, whose wages are subject to FICA and FUTA."[7] It then found Spicer performed substantial services for the taxpayer:

In the present case, Mr. Spicer clearly performed substantial services for the taxpayer corporation. He was the only accountant working for taxpayer, an accounting concern. During the years in question, he performed accounting services for the taxpayer approximately 36

hours a week. He was the only one who signed customers' returns as the preparer, performed financial planning for Taxpayer, audited clients' books, prepared opinion letters for clients, and represented clients before the Internal Revenue Service. He also reviewed and paid Taxpayer's bills, and set Taxpayer's billing rate.[8]

Thus, the Ninth Circuit affirmed the district court and held, "because Mr. Spicer performed substantial services that were essential to Taxpayer, Mr. Spicer should be deemed an employee, and payments to him should be deemed "wages" subject to FICA and FUTA."[9]

Veterinary Surgical Consultants P.C. v. Commissioner[10]

In *Veterinary Surgical Consultants*, a veterinarian, Dr. Sadanaga, organized the taxpayer as an S corporation to provide consulting and surgical services to veterinarians. Sadanaga, who was the taxpayer's president and only officer, generated all of the taxpayer's income by providing consulting and surgical services to the Veterinary Orthopedic Services, Ltd. ("Orthopedic").

The taxpayer made "distributions other than dividend distributions paid from accumulated earnings and profits" to Sadanaga of around $125,000 in 1994, $225,000 in 1995, and $212,000 in 1996. The taxpayer did not issue a Form W-2 to Sadanaga for any of the tax years at issue. On his Forms 1040, Sadanaga reported his share of pass-though income as nonpassive income from an S corporation.

Sadanaga was also an employee of Bristol-Myers Squibb Co., from which he reported wages of around $91,000 in 1994, $95,000 in 1995, and $102,000 in 1996.

On audit, Sadanaga's accountant asserted Sadanaga was not an employee of the taxpayer and that all of the distributions were actually his share of the corporation's net income. The Service disagreed. In Tax Court, the taxpayer asserted Sadanaga was its sole shareholder but not its employee, and it had, therefore, correctly distributed its net income to Sadanaga.

The Tax Court first concluded Sadanaga was an employee. It found Sadanaga, who was an officer of the taxpayer, performed substantial services for the taxpayer because: (1) he worked approximately 33 hours a week; (2) he was the only individual working for the taxpayer; and (3) his surgical and consulting services generated all of the taxpayer's income.

Next, the court concluded Sadanaga received remuneration for the services he provided to the taxpayer. The court said the taxpayer's characterization of the payments as distributions was "a subterfuge for reality." Citing *Spicer Accounting* and *Radtke*,[11] the court explained that, regardless of an employer's characterization, "the true analysis is whether the payments represent remuneration for services rendered."

The Tax Court also established what appears to be a bright-line rule for small, closely-owned and operated S corporations:

Dr. Sadanaga's reporting the distributions as nonpassive income from an S corporation has no bearing on the Federal employment tax treatment of those wages. He was petitioner's sole source of income. And as petitioner's sole full-time worker, he must be treated as an employee. Accordingly, we hold that Dr. Sadanaga is an employee of petitioner for the period at issue and, as such, the payments to him from petitioner constitute wages subject to Federal employment taxes.

Accordingly, the Tax Court ruled the test of employment status is whether payments to the taxpayer represent remuneration for services. It held the payments to Sadanaga constituted wages.

Finally, the taxpayer argued that, because Sadanaga paid the maximum FICA tax required on his wages from Bristol-Myers Squibb Co., it was not required to withhold FICA tax. The Tax Court soundly rejected the argument, explaining the FICA wage base applies separately to each employer:

This argument is simply a "red herring." For Federal employment tax purposes, the taxable wage base applies separately to each employer. Thus, if an employee receives wages from more than one employer, the annual wage limitation does not apply to the aggregate compensation received. The employee, however, may be eligible for a credit or refund of the excess employee portion of the FICA tax that applies with respect to wages in excess of the applicable wage base.

Thus, the Tax Court held Sadanaga was an employee of the taxpayer for the tax period at issue.

Watson, P.C. v. United States[12]

The taxpayer, David E. Watson, graduated from the University of Iowa with a bachelor's degree in business administration and a specialization in accounting. He became a CPA in 1983. In 1996, Watson incorporated DEWPC, a professional corporation which elected to be treated as an S corporation. Watson is the sole officer, shareholder and director of DEWPC. The corporation was a partner in a small accounting firm. In 2003 and 2004, the tax years at issue, he was the only person to whom DEWPC distributed money. His salary in both years was $24,000. In arriving at his $24,000 annual salary figure, Watson had only considered what he thought he could pay an employee on a regular and continuous basis, regardless of the "seasonability" of the business or whether it was a good economy or bad economy. He did not consider what comparable businesses paid for similar services. During 2003 and 2004,

Watson received distributions totaling roughly $320,000.

For each tax year, the Service reclassified $67,044 of the distributions as wages, stating DEWPC structured Watson's salary and distribution payments to avoid federal employment taxes. The Service's recharacterization resulted in a $48,519 employment tax assessment against DEWPC. After making a few payments toward the assessment, DEWPC filed a claim for refund. The IRS denied the claim and DEWPC sued in district court.

The district court held in favor of the Service. It reasoned that Watson was an exceedingly qualified accountant. He has both a bachelor's degree and an advanced degree, and approximately 20 years of experience in accounting and taxation. During 2002 and 2003, Watson worked approximately 35 to 45 hours per week for his reputable and well-established firm, which had more than $2 million and nearly $3 million in gross revenue, respectively, during those years. The court further reasoned that any reasonable person in Watson's role as DEWPC's sole shareholder, officer and employee would have earned more than $24,000, particularly in light of the large distributions he received. Based on these facts and circumstances, the court was convinced that DEWPC structured Watson's salary and dividend payments in an effort to avoid Federal employment taxes, with full knowledge that the distributions to Watson were actually "remuneration for services performed."

Watson appealed the district court decision to the Eighth Circuit Court of Appeals, where he asserted at least two alternative positions:

- The government's expert on the issue of reasonable compensation should not be relied upon; and
- The focus should be on the corporation's intent with respect to compensation rather than on the reasonableness of compensation.

After much discussion, the Eighth Circuit found both of the taxpayer's arguments meritless.

DEWPC asserted the government's expert, among other things, was not qualified to render a reliable opinion on reasonable compensation. He was a certified business valuation analyst but had no credentials specifically relating to compensation. The court concluded the taxpayer's argument was not convincing. The expert was an experienced "general engineer" for the IRS; he spent 40 percent of his time dealing with compensation issues. In fact, he had worked on 20 to 30 reasonable compensation cases. In accordance with Rule 702 of the Federal Rules of Evidence, a witness may qualify as an expert by "knowledge, skill, experience, training or education."

DEWPC also argued the government's expert witness should not be relied upon because he changed his opinions during the lower court proceeding, failed to consider important facts in rendering his opinion and adopted flawed methods to arrive at his conclusions. Unfortunately, DEWPC never raised these objections in the lower court, nor did it introduce evidence through its own expert witness to contradict the government's position.

To address DEWPC's second argument, the Eighth Circuit surveyed the cases on reasonable compensation. "[A] business may deduct a 'reasonable allowance for salaries or other compensation for services actually rendered' as ordinary and necessary business expenses." The determination of reasonableness requires an analysis of all of the facts and circumstances. The lower court considered the relevant facts and circumstances. Nevertheless, DEWPC asserted, rather than focus on reasonableness, the court should have focused on the taxpayer's intent; that is – whether the taxpayer had compensatory intent in making the distributions to Watson.

The court quickly set aside the taxpayer's argument. It stated a deduction for compensation is allowed if it is reasonable and the payments are for actual services rendered. Citing the Ninth Circuit Court of Appeals in *Elliotts, Inc. v. Commissioner*,[13] the court concluded the reasonableness inquiry is so broad, it most often subsumes the intent inquiry. The lower court correctly analyzed the matter with its focus on reasonableness.

Last, DEWPC argued the lower court should have applied the principles of *Pediatric Surgical Associates*.[14] Specifically, DEWPC asserted Watson's reasonable compensation should have been limited to his personal billing receipts less expenses attributable to those receipts. The Eighth Circuit quickly pointed out that Watson was not the only person generating revenue. Non-shareholder employees were also generating revenue. So, merely focusing on Watson's personal time-keeper receipts and expenses attributable thereto was not appropriate in this case. Other evidence is relevant to the inquiry of reasonableness, including but not limited to: (1) business generated by the shareholder employee; (2) the employee's experience, expertise, hours worked and education; (3) lack of arms-length negotiation; (4) compensation history; and (5) the financial ability of the corporation.

The Eighth Circuit, after concluding the lower court's decision was based upon the proper legal standards, affirmed.

Unreasonably High Compensation in the S Corporation Setting

There are significant economic incentives for certain S corporations to pay unreasonably high compensation to shareholder employees.

First, an S corporation may want to pay excessive compensation to its shareholder employees in order to zero out its taxable income in an effort to avoid the built-in gains tax under Code § 1374.

Second, an S corporation may want to pay excessive compensation to its shareholder employees in order to avoid paying the passive investment income tax under Code § 1375 due to the net income limitation contained in Code § 1375(b)(1)(B).

Third, an S corporation may want to pay excessive compensation to its shareholder employees in order to maximize their retirement plan contributions, which are based on compensation.

Finally, an S corporation may be motivated to pay excessive compensation to less than all of its shareholder employees in order to avoid violating the single class of stock requirement under Code § 1361(b)(1)(D).

The Built-In Gains Tax

Code § 1374's built-in gains tax creates an incentive for S corporations that converted from C corporation status to pay unreasonably high compensation. In short, if the S corporation's taxable income can be reduced to zero for each taxable year during the five-year recognition period, the carry-over penalty tax will be eliminated in the sixth year the S election is in effect.

The primary way the S corporation can reduce taxable income is by paying high compensation. If the compensation is too high, it could be challenged by the Service as unreasonable in amount.

The Excess Passive Income Tax

Code § 1375 imposes an excess passive income tax when passive investment income of an S corporation that has accumulated earnings and profits (from C corporation years) exceeds twenty-five (25) percent of gross receipts. Code § 1375(b)(1)(B), however, limits "excess passive income" for a taxable year to the corporation's taxable income. As stated earlier, for this purpose, the corporation's taxable income is determined as if it were a regular corporation, but without regard to the NOL deduction or the dividends received deduction.

So, there is an incentive to reduce the S corporation's taxable income to zero by paying high compensation to avoid the application of Code § 1375. If the compensation is too high, it could be challenged by the Service as unreasonable in amount.

PRACTICE ALERT: Even if a taxpayer is able to zero out taxable income to avoid the application of Code § 1375 in any given taxable year, it may not be out of danger. It must contend with Code § 1362(d)(3).

An S corporation that has C retained earnings and profits and that has passive income that exceeds twenty-five (25) percent of its gross receipts for three (3) consecutive taxable years, will have its S election terminated as of the first day of the next taxable year.[15] So, if an S corporation has C earnings and profits, it may be able to run (using compensation as a shield) to avoid the wrath of Code § 1375, but it will be much harder to hide from the thunder of Code § 1362(d)(3) (i.e., termination of its S election).

Retirement Income

The third reason an S corporation may want to pay unreasonably high compensation to its shareholder employees is to maximize retirement contributions.[16] An illustrative case on this very issue is *LaMastro v. Commissioner*.[17]

Anthony LaMastro formed a professional service corporation taxed under Subchapter S in 1970 to operate a dental practice.[18] The corporation's first fiscal tax year — 1970 — was a short 14 days.[19] During that first fiscal year, the corporation adopted a pension plan, borrowed funds from LaMastro and contributed the borrowed funds to the plan.[20] The corporation's pension plan contribution deduction resulted in a $25,796 net operating loss, which passed through to LaMastro.[21] LaMastro and his wife, Helen LaMastro (the petitioners), reported the net operating loss on their 1970 joint return.[22]

The Service issued a notice of deficiency to Anthony and Helen LaMastro that disallowed the corporation's entire $24,000 retirement plan contribution, thereby increasing LaMastro's distributive share of taxable income. Anthony and Helen LaMastro petitioned the Tax Court. In its amended answer, the Service reduced its disallowance, and later stipulated that only $19,207 of the $24,000 pension plan contribution should have been disallowed.

The Tax Court explained that Code § 404(a) limits allowable deductions to compensation that would otherwise be deductible under Code § 162.[23] It concluded the pension plan contribution was an unreasonably high compensation allowance for services rendered by LaMastro during the corporation's 14-day taxable year.

Accordingly, the Tax Court upheld the Service's disallowance of the petitioners' net operating loss deduction. Deploying increases in shareholder employee compensation to maximize retirement plan contributions comes with significant risk. **Caution is advised!**

Avoid Single Class of Stock Requirement

Finally, an S corporation may be incentivized to pay unreasonably high compensation to some of its shareholder employees to avoid having disproportionate distributions, thereby losing its S election.

Under Code § 1361 (b)(1)(D), S corporations may only have one class of stock. Accordingly, they are required to make shareholder distributions pro rata based on share ownership.

If the corporation wants to treat one shareholder differently than another, because it needs to maintain one class of stock, it may attempt to differentiate the shareholders through shareholder employee compensation.

PRACTICE ALERT: An employment agreement is a "commercially contractual agreement" rather than a "governing provision." Accordingly, unless it is established that the principal purpose of the compensation is to circumvent the single class of stock requirement of Subchapter S, the taxing authorities will not be able to successfully attack the validity of the S election. While the bar may be high for the government to win this debate, the risk exists. **Caution is required.**

Conclusion

Hopefully, the above discussion makes it evident that unreasonable compensation can be an issue in the S corporation setting. The issue is not limited to C corporations!

Robert Southey's fairy tale, Goldilocks and the Three Bears, lives on today through the battle of reasonable compensation between taxpayers and the Service.

Compensation cannot be too high. Likewise, compensation cannot be too low. It must be just right in order to be considered reasonable for tax purposes.

Unfortunately, determining whether compensation is reasonable is not an easy task. There is no objective test. Additionally, there is no consensus among the courts as to which subjective test should be applied to cases. Consequently, the dispute between the Service and taxpayers on this subject appears to be never ending.

Tax advisers need to keep abreast of developments in this area of tax law. They need to know the law in the jurisdiction that governs their clients. Also, they need to be diligent about reviewing the implications of unreasonable compensation decisions with their clients.

Each shareholder employee compensation decision and the compensation decisions for their families should be carefully reviewed before implemented. Appropriate documentation of these decisions is generally warranted.

Unless a uniform objective test is legislatively adopted (which appears unlikely), what constitutes reasonable compensation will be a continuing battle between the Service and taxpayers. **Caution is advised! Remember, the matter of unreasonable compensation is not limited to C corporations.**

---

[1] The 23.8% rate is comprised of the 20% rate on qualified dividend income, IRC § 1(h)(11), and the 3.8% net investment income tax, IRC § 1411.

[2] *Spicer Accounting, Inc. v. United States*, 66 AFTR2d 90-5806, 918 F.2d 90 (9th Cir. 1990).

[3] *Joseph Radtke, S.C. v. United States*, 63 AFTR2d 89-1469, 712 F.Supp. 143 (E.D. Wis. 1989), *aff'd*, 65 AFTR2d 90-1155, 895 F.2d 1196 (7th Cir. 1990).

[4] *Radtke v. United States*, 65 AFTR2d 90-1155, 90-1156, 895 F.2d 1196 (7th Cir. 1990).

[5] *Id.* at 90-1156.

[6] 66 AFTR2d 90-5806, 918 F.2d 90 (9th Cir. 1990).

[7] *Id.* at 90-5808.

[8] *Id.*

[9] *Id.* at 90-5809.

[10] 117 T.C. 141 (2001).

[11] *Spicer Accounting, Inc. v. United States*, 66 AFTR2d 90-5806, 918 F.2d 90 (9th Cir. 1990); *Joseph Radtke, S.C. v. United States*, 65 AFTR2d 90-1155, 895 F.2d 1196 (7th Cir. 1990).

[12] 109 AFTR2d 2012-1059, 668 F.3d 1008 (8th Cir. 2012).

[13] 716 F.2d 1241, 52 AFTR2d 83-5976 (1983).

[14] T.C. Memo 2001-81 (2001).

[15] Code § 1375(d)(3)(A)(ii).

[16] *See, e.g.*, *Bianchi v. Comm'r*, 66 T.C. 324 (1976), *aff'd per curiam*, 39 AFTR2d 77-894, 553 F.2d 93 (2d Cir. 1977).

[17] 72 T.C. 377, 378 (1970).

[18] *Id.* at 378-79.

[19] *Id.* at 379.

[20] *Id.*

[21] *Id.*

[22] *Id.* at 379-80.

[23] *Id.* at 381.

Tags: A Journey Through Subchapter S, built-in gains tax, S corporation