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Higher Employment Taxes on the Horizon for S Corporations

The IRS believes some S corporation shareholder-employees are trying to avoid paying employment taxes by paying themselves little salary and taking large dividend distributions. The Service has begun a concerted effort to help prevent this strategy from succeeding.

S corporation shareholder-employees of professional service businesses (including doctors, lawyers, accountants, consultants, and other service providers) who pay themselves little or no salary and instead take large dividend distributions should beware. The IRS believes these individuals are taking advantage of this strategy to avoid employment taxes. It is pursuing a two-pronged attack on this tactic by making an aggressive effort through the courts to reclassify distributions from S corporations as salaries subject to payroll taxes and by attempting to get Congress to pass legislation that makes certain distributions from S corporations subject to self-employment tax.

Existing Employment Taxes

Social Security and Medicare benefits are financed in part by a tax on the wages of individuals under the Federal Insurance Contributions Act (FICA) and on net earnings from self-employment under the Self-Employment Contributions Act (SECA). A sole proprietor's net earnings from self-employment and a general partner's net earnings from self-employment, including the partner's distributive share of profits as well as guaranteed payments, are subject to the self-employment tax. A limited partner's distributive share of partnership income (other than guaranteed payments for services) is excluded from self-employment tax. Members of limited liability companies (LLCs) that are taxed as partnerships follow the same rules for employment taxes as applies to partners.

The salaries and wages of shareholder-employees of C and S corporations are subject to the same FICA taxes that apply to any other employees, but their dividend distributions aren't subject to self-employment taxes. This provides a significant employment tax savings for S corporation shareholder-employees. These individuals don't pay self-employment tax on their distributive share of profits, as opposed to partners who must pay self-employment tax on all of their partnership earnings.

Some S corporation shareholder-employees of personal service businesses take advantage of this by paying themselves little or no salary and instead taking large dividend distributions. This helps them avoid these employment taxes. When the IRS audits S corporations, it typically examines salaries of shareholder-employees, looking for this type of underpayment. It may reclassify some of the dividend distributions as salary and assess FICA taxes. The following case illustrates how the IRS has been successful in the courts in reclassification of S corporation distributions.

Recent Reclassification Case

In May 2010, the District Court (in *Watson v. U.S.*, 105 AFTR 2d 2010-2624) held that the IRS has the right to reclassify a portion of the dividend distributions by an S corporation to its sole owner. The shareholder-employee in this case paid himself an annual salary of $24,000 and then took additional distributions of $201,651 in one year and $221,577 in the next year. The IRS reclassified $130,730 from the first year and $175,470 from the second year as salary, assessing FICA taxes along with interest and penalties. The taxpayer argued

that the IRS's recharacterization was an impermissible attempt to impose minimum salary requirements. The District Court disagreed with the taxpayer, deciding that the IRS has the right to reclassify a portion of the dividend distribution and subject it to employment tax.

The IRS would prefer to avoid this type of costly litigation through a legislative solution, such as the following proposal that was recently introduced in Congress as part of a bill to generate much-needed tax revenue.

Pending Legislation

The American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213) would change the employment tax rules for S corporation shareholders of some professional service businesses, subjecting their distributive share of profits to self-employment tax. This proposal would apply to an S corporation if (1) most of its activities are for a professional service business conducted by a partnership in which the S corporation is a partner or (2) the S corporation is a professional service business in which the principal asset is the reputation and skill of three or fewer employees. A professional service business would include a business where a substantial part of its activities involve providing services in the fields of accounting, health, law, lobbying, engineering, architecture, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services. This new provision would also apply to the distributive share of profits for limited partners who perform substantial services and LLC members who have been treating their share of LLC profits under the same rules that apply to limited partners.

While the basic approach of placing shareholders of an S corporation professional service business on similar footing as partners by subjecting their distributive share of profits to self-employment tax causes some concern, it is the broad reach of the family attribution provision that has generated the most controversy. Under the family attribution provision, S corporation shareholders who perform substantial services would have to increase their earnings that are subject to self-employment tax by the distributive share of family members. This includes parents, spouse, children, or grandchildren who are shareholders but who do not perform substantial services.

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Let's look at a hypothetical example. Tom is a shareholder-employee of an S corporation engaged in a professional service business. Tom performs substantial personal services. The S corporation pays Tom a salary of $110,000 for his services, and it views this as reasonable compensation. Tom's mother is also a shareholder, but she doesn't perform services for the S corporation. Tom's distributive share of the S corporation profits is $250,000, and his mother's share of S corporation profits is $250,000. Under the proposal, Tom would be subject to self-employment tax on $500,000 (Tom's $250,000 plus his mother's $250,000) in addition to the regular FICA tax on his $110,000 salary.

There have been significant attempts in the Senate to eliminate or scale back this provision. Even if the provision doesn't pass this year, something similar is certain to be raised again in the near future as Congress continues to struggle with its need to raise revenue. With the recent expansion of Medicare taxes to unearned income that starts in 2013, it's no surprise that an expansion of self-employment tax would also be proposed to profits from flow-through entities. Until this or similar legislation passes, taxpayers should expect the IRS to continue its aggressive approach to employment taxes in the courts, so S corporation shareholder-employees should ensure they pay themselves salaries that will be considered reasonable compensation for their services. **SF**

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