

## Watch Out How You Pay Out S Corporation Distributions

David E. Watson PC v. United States

S.D. Iowa

No. 4:08-cv-442

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Many physician practices are organized as S corporations. One main reason is that money can be taken out of the corporation as compensation and dividends (distributions). While compensation is subject to employment taxes, the distributions are not. This Watson case makes us think about how physicians pull money out of their own S corporation.

Watson, an accountant, formed a corporation we'll call DEWPC. DEWPC elected to be taxed as an S Corporation, and Watson had been its sole shareholder, employee, director, and officer. Watson set his salary compensation at \$24,000.00 and took monies out as distributions. On or about February 5, 2007, the Internal Revenue Service ("IRS") assessed taxes, penalties, and interest against DEWPC because the IRS determined that portions of the dividend distributions paid from DEWPC to Watson should be recharacterized as wages paid to Watson, subject to employment taxes.

In its Motion for Summary Judgment, DEWPC contended that it "clearly intended to pay Watson compensation of \$24,000 per year, and that amounts distributed to Mr. Watson in excess of that amount were properly classified as dividends. The intent to pay Watson a salary of only \$24,000 was clearly evidenced by the Minutes of the Combined Meeting of the Shareholders and Directors of DEWPC during the relevant time frame, which all evidence the fact that DEWPC intended to pay Watson the \$24,000.00 as annual salary, and intended to pay dividends "in the amount of available cash on hand after payment of compensation and other expenses of the corporation

The IRS stated in its response that DEWPC's position that its own intent controls the characterization of funds paid to Watson is undermined by relevant IRS Revenue Rulings and by case law. In Rev. Rul. 74-44, the IRS stated that the dividends paid "were reasonable compensation for services" performed by the shareholders "rather than a distribution of the corporation's earnings and profits." In *Joseph Radtke, S.C. v. United States*, a district court determined that certain funds designated as dividends were actually compensation for which an S Corporation owed employment taxes.

Relying on *Radtke* and the related Revenue Ruling, the Ninth Circuit also determined that payments designated as dividends can properly be recharacterized by the IRS as wages subject to federal employment taxes (*Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990)). Citing *Radtke*, the *Spicer* court found that, "regardless of how an employer chooses to characterize payments made to its employees, the true analysis is whether the payments are for remunerations for services rendered and "Mr. Spicer's intention of receiving the payments as dividends has no bearing on the tax treatment of these wages."

In *Veterinary Surgical Consultants v. Commissioner of Internal Revenue*, the United States Tax Court rejected a petitioner's argument that amounts paid to its sole shareholder were distributions of corporate net income rather than wages. The Court said an employer cannot avoid Federal employment taxes by characterizing compensation paid to its sole director and shareholder as distributions of the corporation's net income, rather than wages. Regardless of how an employer chooses to characterize payments made to its employees,

the true analysis is whether the payments represent remunerations for services rendered.

Likewise, in *JD & Associates, Ltd. v. United States*, Jeffrey Dahl, the sole shareholder, officer, and director of the plaintiff S corporation, received an annual salary of \$19,000.00 in 1997 and \$30,000.00 for each of 1998 and 1999. As in the present case, the IRS determined that Dahl's salary was unreasonably low, and assessed employment taxes, interest, and penalties against the corporation after recharacterizing portions of the dividend payments as wages to Dahl. The Court applied Eighth Circuit tests to determine whether Dahl's compensation was reasonable. The following tests employed were derived from *Charles Schneider & Co., Inc. v. Commissioner of Internal Revenue*:

- Employee's qualifications
- The nature, extent and scope of the employee's work
- The size and complexities of the business
- A comparison of salaries paid with the gross income and the net income
- The prevailing general economic conditions
- Comparison of salaries with distributions to stockholders
- The prevailing rates of compensation for comparable positions in comparable concerns
- The salary policy of the taxpayer as to all employees
- In the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.

After careful review of the relevant authorities, the Court agreed with the IRS that DEWPC's self-proclaimed intent to pay Watson \$24,000.00 in salary did not limit the United States' ability to recharacterize dividends paid to Watson as wages, even though DEWPC properly documented its claimed intent in its corporate records. The Court stated that ultimately the characterization of funds disbursed by an S corporation to its employees or shareholders turns on an analysis of whether the "payments at issue were made ... as remuneration for services performed." The Court reminded us in this case that the substance of a transaction controls its tax treatment.

This case again warns us that we should take a look or relook at how shareholders take money out of an S corporation. As you can see, the IRS can come in and recharacterize payments as wages subject to employment taxes. If anything, make sure compensation is supported by relevant physician compensation surveys to support a position that salary taken out of the S corporation was and is in fact "reasonable."