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Eighth Circuit Affirms District Court in S Corporation Reasonable Compensation Case

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Last fall, we covered *Watson v. United States,*[1] at the tax schools. That's the case involving the question of reasonable compensation in an S corporation – the issue that former Senator and Presidential candidate John Edwards has become the poster child for. He ran his law practice through an S corporation and took the majority of his earnings out of the S corporation in the form of distributions that aren't subject to payroll tax. Warren Buffet does the same thing with his company, Berkshire Hathaway. He only takes a salary of approximately $100,000, roughly the FICA tax wage base. The United States Court of Appeals for the Eighth Circuit has now affirmed the trial court's decision in *Watson* that the shareholder was paid an unreasonably low salary.

Overview

S corporation shareholders are subject to payroll taxes on wages that they are paid. That's nothing new. In fact, IRS issued a revenue ruling in 1959, *Rev. Rul. 59-221,*[2] noting that S corporation shareholders are subject to payroll taxes for work that they do for the S corporation that is compensated in the form of wages. Later, in *Rev. Rul. 74-44,*[3] IRS said that dividend payments to S corporation shareholders could be recharacterized as wages to the extent they are replacing reasonable compensation from the S corporation. Then, when President Clinton signed legislation into law that repealed the cap on the Medicare portion of the FICA tax (2.9 percent), the reasonable compensation issue became huge. It created a big incentive for S

corporation shareholders to limit salaries to the FICA tax wage base applicable to the OASDI portion because of the ability to avoid a 2.9 percent tax on an unlimited amount of income. But, what if the salary is less than that base? That raises the question of what constitutes a reasonable salary. That really isn't an issue, apparently, if the salary is at or above the FICA tax wage base for OASDI purposes ($110,100 for 2012). Apparently Warren Buffet's tax advisors know that because, as noted above, his salary is kept very close to the wage base.

> **Note:** *There aren't any published opinions involving the issue of reasonable compensation where the salary was at least up to the FICA wage base.* The published opinions all involve salaries less than the wage base. This is a point that some commentators fail to make.

So, if S corporation dividend payments to a shareholder are really for services rendered to the S corporation, IRS can reclassify them as "wages" if the amount is less than what IRS deems to be reasonable compensation for services rendered. That's an issue that depends on the facts of any given case – determining the appropriate line between a shareholder's income derived from investment in the business (not subject to payroll tax), and remuneration for services. To answer that question, comparable salary data becomes very relevant – what are other similarly situated persons to the shareholder paid, and what would it cost to

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replace the particular shareholder

The *Watson*[4] Case

In *Watson*, the taxpayer had been a CPA since 1983 and had a master's degree in taxation. He worked for a major CPA firm for nine years before becoming a 25 percent partner in LWBE, an accounting firm. Four years later, he formed an S corporation, DEWPC, which became a 25 percent shareholder in LWBE in the place of the taxpayer. LWBE later became LWBJ, and the taxpayer provided accounting services to LWBJ as an employee of DEWPC. The other CPAs in the firm also established their own S corporations such that the structure of the CPA firm was as a partnership of S corporations.

DEWPC distributed $24,000 to the taxpayer as employment compensation in each of 2002 and 2003, the years at issue. In addition, the taxpayer received $203,651 as a profit distribution from DEWPC in 2002 and $175,470 as a profit distribution in 2003. IRS audited and assessed DEWPC for additional taxes, penalties and interest for underpaid employment taxes. DEWPC paid the deficiency and sought a refund. IRS denied the refund and DEWPC sued. The trial court ruled for the IRS, finding that the taxpayer's reasonable salary (based on an analysis of industry compensation by the IRS expert which the court determined was credible) should have been $91,044 for each of 2002 and 2003 (the OASDI portion of FICA tax wage base was $84,900 in 2002 and $87,000 in 2003). Indeed, the taxpayer was paid less in salary than what a new CPA fresh out of school could anticipate as a starting salary. As a result, the unpaid employment taxes, penalties and interest exceeded $23,000.

On appeal, the court noted that "wages" is statutorily defined as "all remuneration for employment" and that FICA imposes "on every employer an excise tax, with respect to having individuals in [its] employ…". So, the issue was whether the payments to the taxpayer were remuneration for services that the taxpayer performed. The court noted that "special scrutiny" is given to salaries paid to sole shareholder/employees, such as the present case.

The taxpayer pointed out that there is no statute, regulation or rule requiring an employer to pay minimum compensation, and that the taxpayer's intent should control the characterization issue. But, the court noted that *Rev. Rul. 74-44,*[5] had long established the position of the IRS on the matter of reasonable compensation and was entitled to substantial deference. The court also pointed out that other courts examined the economic substance of the transaction rather than the form that the taxpayer chose. In other words, the taxpayer's intent as to characterization was irrelevant.

The bottom line is that S corporation salaries must not be set too low in an attempt to avoid payroll taxes. The good news, however, is that "reasonable compensation" does not mean that all of the corporation's earnings have to be in the form of wages.

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[1] 757 F. Supp. 2d 877 (S.D. Iowa 2010).
[2] 1959-1 C.B. 225.
[3] 1974-1 C.B. 287.
[4] David E. Watson, P.C. v. United States, No. 11-1589, 2012 WL 539784 (8th Cir. Feb. 21, 2012).
[5] 1974-1 C.B. 287.