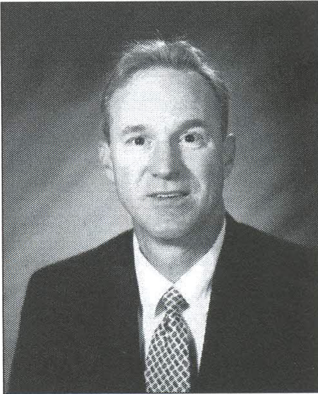
Payroll Taxable Wages Of An Owner And Employee Of An S Corporation



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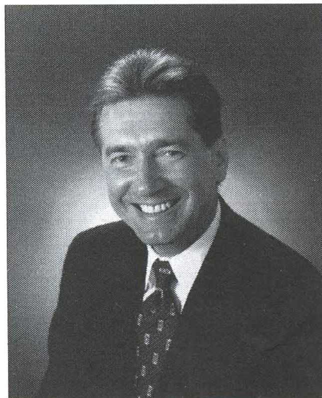

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By Mark P. Altieri, William P. Prescott, and Kelly A. VanDenHaute

Be careful about payroll tax avoidance situations — IRS Is looking for them.

LAY PEOPLE AND TAX PROFESSIONALS alike generally perceive S corporations and partnerships to be similar tax "flow-through" entities. That is, the S corporation or partnership is not the taxpayer; rather, tax items generated at the entity level are flowed through to the owners via a Schedule K-1 and are attended to only at the owners' level for tax purposes.

Despite the fact that S corporations and partnerships and their respective owners are generally treated alike for federal tax purposes, many meaningful distinctions do exist between the tax treatment of S corporations and partnerships. For a more detailed study of the tax differences between partnership entities and S corporations, *see* Altieri and Cenker, *Partnerships, LLCs, and S corporations: Selected Tax Issues,* 72 CPA Journal 40-47 (October 2002); and Altieri, *Considerations in Determining Whether to Elect S corporation or LLC Status,* 27 Tax Adviser 547-553 (1996).The topic of discussion in this article focuses on only one of these distinctions — the varying payroll tax treatment afforded to operating income flowing through to partners in a partnership and shareholders of an

S corporation. The extent to which this payroll tax differential is being utilized in the formatting of business entity selections for professional practices is additionally examined.

CURRENT LAW OVERVIEW • Ordinary income items from a partnership conducting an active business that are flowed-through to a general partner constitute self-employment income subject to payroll tax. This is the case whether those income items take the form of guaranteed payments or constitute the partner's share of net operating income noted on line 1 of the partner's Schedule K-1.

The payroll tax treatment of net operating income to the owner/employee of an S corporation is significantly different. Not long after the advent of S corporations, the Internal Revenue Service issued a pro-taxpayer ruling with regard to payroll taxation issues. This ruling, Revenue Ruling 59-221, 59-1 C.B. 225, was in stark contrast to the IRS' long-held position on payroll taxation for partners in a partnership. In Revenue Ruling 59-221 there was a distinction made between W-2 wages paid to a owner/employee of an S corporation as an employee of the corporation and any residual net operating income flowed through to the S corporation shareholder on the Schedule K-1 by virtue of his or her stock ownership. With regard to the latter distributable net operating income, the IRS ruled that it was not subject to payroll tax.

In practice, this position of the IRS has tempted S corporations to underpay their shareholder/employees for services the employees actually perform for the corporation while making up the difference in the form of more distributable net operating income. Other than for payroll tax purposes, a shareholder/employee of an S corporation would not care if wealth flowing through to him or her from the S corporation was denominated as wages or as a share of net operating income.

For example, let's say that Joe is the sole shareholder and president of ABC Co., an S corporation. Joe renders services to the corporation reasonably worth $200,000 in 2010. The corporation's net operating income (after all operating expenses other than Joe's compensation expense) is $1 million dollars. If ABC paid Joe $200,000 in W-2 wages for his services, the $800,000.00 of residual net operating income would flow through and be taxed to Joe as ordinary income. If ABC did not pay Joe any W-2 wages, a full $1 million of net operating income would be flowed-through to Joe on the K-1. Although Joe's income taxation would be the same either way, the payroll taxation would vary greatly depending on which approach was taken.

If the second approach could be implemented without challenge by the government, both the S corporation employer and the employee would reap an immediate windfall by avoiding the current 12.4 percent social security tax up to the Social Security wage base ($106,400.00 in 2010). The elimination of any wage cap on the 2.9 percent Medicare portion of FICA has provided even more incentive for S corporations to attempt to under-compensate their shareholder/employees.

To what extent can S corporations and their shareholder/employees engage in this form of tax avoidance? In Revenue Ruling 74-44, 1974-1 C.B. 287, shareholders performing services to their S corporation were paid no W-2 salary but had significant amounts of net operating income in amounts they otherwise would have received as reasonable compensation for services performed. On these facts, the government had little trouble determining that the distributions to the shareholders should be recharacterized as W-2 wages subject to social security payroll taxation as opposed to non-payroll taxable net operating income.

This issue has been litigated many times by the IRS. Generally, and particularly in egregious fact situations like that in Revenue Ruling 74-44, the government has been successful in recharacterizing distributions of net operating income to under-compensated employees as payroll taxable W-2 wages.

The key to the authority in this area is whether the amount the S corporation pays the shareholder/employee as W-2 wages is reasonable relative to services rendered by that shareholder/employee to the corporation. If the facts indicate that the shareholder/employee is clearly being under-compensated with his or her W-2 wages, the courts generally will agree with the IRS that some or all of the distributable net operating income should be recharacterized as payroll taxable W-2 wages. *Radtke v. United States,* 712 F. Supp. 143 (ED Wis. 1989), 895 F.2d 1196 (7th Cir. 1990); C.D. *Ulrich, Ltd. v. United States,* 692 F. Supp. 1053 (D. Minn. 1988); *Dunn & Clark, P.A. v. Comm.'r.,* 853 F. Supp. 365 (D. Idaho 1994); *Watson v. United States,* 105 AFTR 2d 2010 (D.C. IA 2010). *See also,* IRS Fact Sheet 2008-25 (August, 2008), Spradling, *Are S Corp. Distributions Wages Subject to Withholding?* 71 J. Tax'n 104 (1989); Clements & Streer, *How Low Can Owner-Employee Compensation Be Set to Save on Employment Taxes?* 2 J. S Corp. Tax'n 37 (Fall, 1990); Looney & Comiter, *Reasonable Compensation: Dividends vs. Wages – A Reverse in Positions,* 7 J. Partnership Tax'n 364 (1991).

Note that the IRS' point of reference in this situation is exactly the opposite of its analysis of reasonable compensation paid to shareholder/employees of a regular C corporation. C corporations frequently attempt to overstate tax-deductible compensation paid to shareholder/employees so as to minimize dividends to those same shareholders and avoid double taxation of wealth being transferred from the C corporation to the shareholders. In the C corporation situation, the IRS will frequently argue that nominal tax-deductible compensation paid to shareholder/employees is too high in an attempt to recharacterize it as a double-taxed dividend distribution.

As illustrated earlier, for income tax purposes, the amount of tax-deductible compensation paid to an S corporation shareholder/employee is often irrelevant since any residual net operating income will be income taxed only once (and be available for distribution) at the shareholder level anyway. In the S corporation situation, the IRS is arguing that there is an unreasonably low level of Social Security taxable compensation paid to the shareholder/employees and that residual net operating income are commensurately too high. The IRS will then contend that the level of compensation should be recharacterized up with residual net operating income recharacterized down.

The net result is that unlike general partners in a partnership who have a virtually impossible task in avoiding social security taxation, a shareholder/employee of a profitable S corporation may well avoid social security tax at both the employer and employee level as long as an arguably reasonable amount of W-2 wages is paid. Any residual net operating income after wage expense is available payroll tax-free.

CURRENT LAW: TIERED ENTITIES • A very common form of professional practices doing business is to have the actual practice conducted out of a partnership entity that is owned by multiple S corporations. Each licensed professional is the sole owner of his or her S corporation that in turn is the partner or member in the underlying general partnership or limited liability company.

The partnership entity, through which the actual practice is conducted, typically pays the operating costs of the practice. The partnership entity will additionally contract with each S corporation for the provision of professional services through each professional shareholder. The net operating profit of the partnership is Schedule K-1d to each S corporation owner on a pro-rata basis. Each S corporation will then typically pay some W-2 wage compensation to its professional shareholder/employees but in an amount that is often less than that S corporations' share of the net operating income being Schedule K-1d to it by the partnership. In addition to the court-sanctioned approaches for attacking abusive fact situations discussed above, the

government has attempted to completely disregard the interposed S corporations using the tiered entity format.

Grigoraci v. Commissioner, T.C. Memo 2002-202, involved a public accounting firm practicing through a West Virginia general partnership. The practice partnership was previously owned by two S corporations, each of which was wholly owned by the two CPAs rendering services to the practice (the exact tiered arrangement just described). When Victor Grigoraci became a one-third equity owner in the practice, he likewise did so through a wholly-owned third S corporation (GSC). Grigoraci had his S corporation pay him W-2 wages of $32,000 that were both income and payroll taxed. The remaining net operating profit ($74,799) from his share of the practice was Schedule K-1d to him and subjected to income tax only.

Rather than argue relative undercompensation for the value of Grigoraci's services (the general theme of the case authority cited above), the government attorneys argued that GSC was formed for tax-avoidance purposes and should be disregarded for tax purposes. The Tax Court held, however, that the evidence indicated that Grigoraci formed GSC to limit his potential personal liability and not primarily to avoid payroll taxation.

Without so opining, the clear implication of the Court was that if GSC's existence had no effect on Grigoraci's personal liability, i.e., the practice was conducted through a limited liability company as opposed to a general partnership, the government's argument could well be meritorious.

RECENT PROPOSED LEGISLATION • H.R. 4213, the American Jobs, Closing Tax Loopholes and Preventing Outsourcing Act of 2010, was passed by the House in May, 2010. The House-passed bill retroactively reinstated and extended for one year a number of expiring tax breaks for businesses and individuals. Its revenue raisers included a crackdown on using S corporations as a way to minimize Medicare and Social Security taxes that would have largely shut down the payroll tax avoidance described above. In June, the Senate Democratic leadership failed to attract the 60 votes necessary to invoke cloture on the House's extenders bill. What would have happened if it had passed?

Under the rejected legislation, in the case of certain professional service businesses, a shareholder of a "disqualified" S corporation who provides substantial services must take into account for self-employment payroll tax purposes, his or her pro rata share of S corporation income or loss. A shareholder's pro rata share of S corporation income or loss attributable to the professional service business also includes the pro rata share of each member of that shareholder's family for payroll tax purposes. This applies if the family member does not provide substantial services with respect to the professional service business and includes an individual's spouse, parents, children and grandchildren. Further, as under current law, any wages of the shareholder from the disqualified S corporation are subject to payroll taxation (the actual W-2).

A disqualified S corporation is defined as:

- An S corporation that is a partner in a partnership that is engaged in a professional service business if substantially all of the S corporation's activities are performed in connection with the partnership business (the tiered situation described above); and
- Any other S corporation that is engaged in a professional service business if the principal asset of the business is the reputation and skill of three or fewer employees. A professional service business for this purpose means a trade or business, substantially all of the activities of which involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services.

CONCLUSION • With future legislation similar to the recently rejected amendments to H.R. 4213 possibly on the horizon, the tax adviser and professional business person should be on alert for particularly egregious payroll tax avoidance fact situations (such as those in Revenue Ruling 74-44) and understand that the IRS agents are on heightened alert as to this issue.

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