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S Corporations v. Payroll Taxes: A Balance of Salary and Distributions

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A recent tax case won by the IRS has closed a loophole employed by S corporations to circumvent paying payroll taxes by characterizing their wages as distributions. This ruling might have serious repercussions in the business world, especially for S corporations. Let us, to some extent, explore the ruling and dissect it.

SOME BACKGROUND ON S CORPORATIONS

S Corporations are often a popular business option for private firms with less than 100 shareholders and one class of stock, among other esoteric requirements. S corporations enjoy pass through taxation. In other words, S Corporations pass profits and losses to shareholders who pay taxes on such disbursements at their own individual tax rates thus avoiding paying taxation at corporate level. Please, note this is a very simplistic account of taxation of S Corporations.

In addition, S corporations enjoy another tax benefit. Money can be taken out of S Corporations as both compensation and dividends. While compensation is subject to employment taxes (i.e. social security and Medicare), distribution as dividends are *generally not subject to* such taxes.

SOME FACTS OF THE RECENT TAX CASE (David E. Watson P.C. v. US)

In this case, David E. Watson P.C. v. US, Mr. Watson formed an accounting corporation and elected it to be taxed as an S Corporation. Mr. Watson was the sole shareholder, officer, director, employee and officer of such S Corporation. The S Corporation set Mr. Watson's salary at $24,000 for each of 2002 and 2003. In addition, for each of 2002 and 2003, Mr. Watson received distributions far higher than the salary, $203,651 and $175,470 respectively. In 2007, the IRS assessed the s Corporation taxes, penalties and interest. The IRS reasoned some of the distributions made to Mr. Watson should be re-characterized as salary and subject to employment taxes.

SOME REASONING BEHIND THE DECISION

The S Corporation sought to dismiss the case contending that the S Corporation clearly INTENDED to pay Mr. Watson salary of $24,000 and INTENDED to pay distributions after payment of all expenses based on the amount of cash on hand. The IRS responded such position by the S Corporation is undermined by both case law and revenue rulings. The IRS contended the S Corporation's intent to characterize the earnings as distributions and not salary was irrelevant. The salient point was whether such distributions were "for remunerations for services rendered." The IRS contended an S Corporation cannot avoid paying employment taxes by characterizing large portions of profits as distribution rather than salary especially when salary is unreasonably low.

SALIENT LESSON LEARNED

As this recent case illustrates, S Corporations cannot set their salary unreasonably low and reap the profits through far higher distributions without paying taxes.

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