Payroll Taxes and S Corporations (Again)

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Newt Gingrich may be the latest public figure to face scrutiny over how much pay he takes from S corporations, but he is unlikely to be the last. There has been a recurring if not persistent discussion of this tax issue over the last 20 years. It may finally be coming to a head, again. We are talking, of course, about payroll taxes and the flip side of the reasonable compensation coin.

Pundits suggest that Gingrich should not have avoided thousands of dollars of Medicare payroll taxes in 2010. How did he do it? He ensured that the lion's share of monies emanating from his several S corporations came *via* dividend distributions and not in the form of salary or bonus. How legitimate or questionable you may find this depends on your perspective.

Yet it also depends hugely on the facts, and precisely who did what, when and to what effect. After all, in any reasonable compensation case, whether one is asking what is unreasonably high or unreasonably low pay, much depends on overall reasonableness.

Inherently, that is not a bright line. Medicare taxes are levied at a rate of 2.9 percent on an unlimited amount of compensation and self-employment income. Self-employment income would include services rendered as a proprietor, consulting under a consulting contract, fees for speeches or book royalties.

Key to Gingrich, though, it would not include profits from a business. Gingrich treated $444,327 of the payments from his two S corporations, Gingrich Holdings, Inc. and Gingrich Productions, as compensation. That left $2.4 million of earnings as profits or dividends. Gingrich follows in some well-known footsteps, including John Edwards.

The IRS takes the position that distributions to the owner of an S corporation should be treated as compensation to the extent they are associated with the owner's personal services or services to the firm. Earnings that come from the owner's investment of capital and equipment or from the work of others can be treated as profit. The case law dealing with this issue, as with the case law dealing with how much compensation is too much, is mixed.

Trying to minimize amounts subject to payroll taxes may be frowned upon by the IRS. Yet it is hardly unusual and certainly not illegal. In fact, like so much else done by savvy taxpayers and their advisors, it is to be expected when faced with choices and the planning opportunities they present.

There is nothing new about this. The incentive to prefer dividend or profit distributions to payroll have been in the Code since 1993. In 1993 Congress lifted the cap on earnings subject to the 2.9 percent (combined employer and employee) Medicare tax. Even before that there was a less obvious and less rewarding reason to prefer non–service pay.

Messy Disputes

Fighting about these issues in more than a theoretical way is time-consuming. Auditing to determine how much is enough (or how much is too much) is inefficient. Of course, one must draw a line between closely held and public companies. Public companies face the gauntlet of Code Sec. 162(m) and its $1 million deductible compensation limit.

Privately held companies face a more amorphous test. How much compensation can be deducted as reasonable? By even uttering the phrase "reasonable compensation," you reveal that you are considering a closely held company.

Depending on your identity and circumstances, you may find yourself arguing that a distribution is a dividend or that it is not. The term "reasonable compensation" invariably is used when a business is seeking to deduct payments made to officers, directors and/or shareholders. Increasingly, however, this phrase suggests one of the recurring dichotomies in our tax law.

What is reasonable today and what was reasonable 30 years ago may be very different. It does not seem overly cynical to suggest that virtually anything is reasonable in our post–Gordon Gekko climate. Even after Wall Street bailouts, huge compensation packages for services rendered may not raise an eyebrow.

Yet the fundamental tax principles remain largely unchanged. Closely held companies are required to demonstrate that something paid as compensation is reasonable to be deductible. The deduction at the corporate level (for a C corporation) has considerable value, even if payroll taxes have to be paid.

Yet the prevalence of flow-through entities since 1986 is one reason there is a paucity of reasonable compensation tax cases these days. Another is the perception that just about any outsize compensation is reasonable today. In the S corporation context, early case law established that the IRS could attribute (reasonable) compensation where none was paid.

It must be remembered that although the unlimited payroll tax exposure came into the law in 1993, the incentives to favor dividend distributions from S corporations existed before 1993. With unlimited amounts of pay subject to payroll tax, the stakes got much bigger in 1993. The IRS would argue that the corporation should have paid amounts as compensation rather than as dividends.

The early case law dealt with egregious situations in which it was clear that services were being rendered (in some cases by a sole shareholder employee). The decisions in these cases were simple, since not one penny of compensation was paid. [*See Spicer Accounting*, CA-9, 91-1 USTC ¶50,103, 918 F2d 90 (1990). *See also J. Radtke*, DC-WI, 89-2 USTC ¶9466, 712 FSupp 143 (1989), *aff'd*, CA-7, 90-1 USTC ¶50,113, 895 F2d 1196 (1990).]

After early authority with such an obvious outcome, taxpayers became at least slightly more sophisticated. They began to bifurcate payments. Planners had the S corporation pay out a relatively small amount for services rendered, with much of the corporate income passed through to the sole (or the handful of) closely held shareholders as dividends. This strategy achieved national prominence with John Edwards, who reportedly paid himself a salary of $360,000 (on which payroll taxes were paid). He distributed the bulk of the income (about $5 million) as a distribution of S corporation profits.

The colloquy in the tax press at the time generally concluded that it was largely a factual question of how much compensation was "reasonable." Some portion of the income Edwards received was surely allocable to his own legal services. Some was surely attributable to his ownership of (and capital invested in) the firm.

But how much? The press suggested that it would be hard for the IRS to show that the amounts Edwards had the corporation distribute to himself as "dividends" were actually disguised compensation. In fact, these cases may be more difficult than traditional reasonable compensation cases.

Interestingly, management services rendered by Edwards, like legal services, would presumably be viewed as part of the compensation element. Edwards currently awaits trial on charges relating to alleged campaign violations.

IRS Fact Sheet 2008-25

IRS Fact Sheet 2008-25 provides information on just this issue, earmarking the topic for S corporations and their owners. What is the proper tax treatment when officers of the S corporation perform services for the entity? The Fact Sheet warns S corporations not to attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses and/or loans rather than wages.

It goes on to state that the fact that an officer is also a shareholder does not change the requirement that payments to that officer should be treated as wages. Pay is pay. The Fact Sheet stresses that the courts have "consistently" held that S corporation officers/ shareholders who provide more then minor services to the company and receive (or are entitled to receive) payment are employees.

That means their compensation is subject to federal employment taxes. The IRS seems to suggest that this means all. [*See Yeagle Drywall Co., Inc.*, CA-3, 2003-1 USTC ¶50,141, 54. FedAppx 100 (2002), *cert. denied*, 539 US 943 (2003). *See also Nu-Look Design, Inc.*, CA-3, 2004-1 USTC ¶50,138, 356 F3d 290 (2004).]

How Much Is Reasonable?

Traditional reasonable compensation tax cases are relatively rare these days. By traditional reasonable compensation cases, I mean cases in which the taxpayer is arguing the company can deduct a whopping payment because it is reasonable compensation for services rendered. The reverse variety of reasonable compensation case is how much is too little.

These seem to be hatching more and more. IRS Fact Sheet 2008-25 may be intended to scare small businesses into paying all amounts out as compensation. Most tax advisors are likely to think such a reaction would be going too far.

In fact, the Fact Sheet itself states that distributions and other payments by the S corporation to officers must be treated as wages "to the extent the amounts are reasonable compensation for services rendered to the corporation." The question, of course, is just what constitutes reasonable compensation. There's the conundrum again.

The taxpayer has an incentive to err on the low side of reasonable. This compares to the old days in a C corporation context, where the taxpayer had an incentive to err on the high side of reasonable. But within this vast frontier, how does one set it?

The Fact Sheet acknowledges that there are no specific guidelines for what constitutes reasonable compensation (viewed from either perspective) in the Code or Regulations. This requires nitty-gritty factual analysis. With a kind of all-facts-are-relevant expansiveness that seems reminiscent of independent contractor v. employee analysis, Fact Sheet 2008-25 simply lists a variety of factors that the courts have considered in determining what is reasonable. These include the following:

- Training and experience
- Duties and responsibilities
- Dividend history
- Time and effort devoted to the business
- Payments to non-shareholder employees
- The timing and manner of paying bonuses to keep personnel
- Compensation agreements
- The amount comparable businesses pay for similar services
- Using a formula to determine compensation

Change the Law

One proposal nearly became law in 2010 as part of the Unemployment Compensation Extension Act of 2010 (also known as the American Jobs and Closing Tax Loopholes Act of 2010), H.R. 4213. It was decidedly not Solomonic in approach. Just tax it all, it said.

This proposal was projected to raise $11 billion over 10 years by automatically imposing payroll tax on all the distributions to owners of certain professional service S corporations. Over strong objections, the Senate eventually dropped the proposal. Yet with the Gingrich-linked resurgence, the issue has returned and the dollars are not insignificant. A new bill has surfaced. Pete Stark (D-Calif.) recently reintroduced the legislation with H.R. 3840, Narrowing Exceptions for Withholding Taxes Act of 2012, or the NEWT Act.

Like its 2009 predecessor, the NEWT Act would clamp down on the owners of certain S corporations. Shareholders who provided services to "Disqualified S Corporations" would have faced self-employment tax on the distributions they received from the corporation even if those payments were characterized as dividends or profits. Since the self-employment tax embodies both the employer's and employee's share of employment tax, it would correspond to wage treatment.

The NEWT Act would cut a wide swath through closely held companies *via* a broad definition of Disqualified S Corporations. As proposed, disqualified S corporations would include:

- any S corporation which is a partner in a professional service partnership, where the services are substantially all of the activities of the corporation; and
- any S corporation engaged in professional services if the principal asset is the reputation and skill of three or fewer employees.

Professional service businesses are those where substantially all of their activities involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management and brokerage services. Considering that "consulting" is among the culprits named, it is a broadly applicable list.

As if this weren't enough, Mr. Stark has also proposed family attribution. Even if family members do not provide any services to the corporation, if they receive dividend or profit distributions from the S corporation, there would be more tax to pay. In such a case, the service provider would be thwacked with self-employment tax on *all* of the monies paid to the family members.

Conclusion

What is reasonable—too high or too low—is unlikely to be the subject of universal agreement. There will usually be subjective criteria and it sometimes seems that virtually anything is reasonable to someone. That suggests this area, not unlike disputes among appraisal specialists over valuation matters, may come down to a battle of the experts.

In that sense, some variety of deemed solution that treats some or all distributions as pay may be efficient, even if it is unpopular. After all, the taxpayer incentive to err on the side of noncompensation is clear.

Indeed, it is increasing. Commencing in 2013, under President Obama's new health reform law, couples with compensation exceeding $250,000 (and singles with more than $200,000 in compensation) are destined to pay an additional 0.9-percent Medicare surtax on their pay above these amounts.

That may be just one more reason that the line between the reasonable and the unreasonable is likely to get murkier still.

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