S CORPORATION AND LLC UPDATE

Status of Legislation Proposed in 2010;

Adequate Compensation for S Corporation Shareholder-Employees

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This outline should be viewed only as a summary of the law and proposed laws, and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.

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1. 2010 Legislation, Enacted and Not Enacted

1.1. Enacted: 5-year recognition period for S corporation built-in gain

2010	2011	2012
7 years[1]	5 years[2]	10 years

1.2. Enacted: S corp stock basis after charitable contributions by the corporation

- The special rule for basis adjustments to S corporation stock for corporate-level charitable contributions of property was extended.[3] The rule limits the stock basis reduction to the corporation's basis in the donated item, even if the deduction amount is based on the fair market value of the item. This gives the shareholder the best of both worlds (high deduction, low basis reduction), and encourages charitable contributions.

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[1] I.R.C. § 1374(d)(7)(B)(i). California has not conformed.

[2] I.R.C. § 1374(d)(7)(B)(ii). The federal recognition period reverts to 10 years after 2011. I.R.C. § 1374(d)(7)(A).

[3] I.R.C. § 1367(a)(2) as amended by the 2010 Tax Relief Act, § 752.

1.3. Not enacted: Carried interests[4]

- The premise that the promoters of private equity funds should not be able to "convert ordinary income into capital gain" yielded draconian proposed legislation.
    - Proposed: All realized gain is recognized, no gain is deferred
    - Proposed: All gain is ordinary income
    - Proposed: Would apply to gain of investment managers in the managed business
- Expected to raise $18.7 billion over 10 years.
- A new 40% penalty on underpayments to avoid these provisions was also proposed.
- This group of proposals was deleted from the Small Business Jobs Tax Act of 2010, but remains a threat as a possible revenue-raiser in a future bill.

1.4. Not enacted: Synthetic ("disqualified") interests in entities[5]

- Income or gain on synthetic interests in equity interests of any entity would be ordinary income if the holder of the interest performs "investment services" for the entity and the interest changes in value based on the income or gain of the managed assets.

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[4] H.R. 4213; see my outline *LLCs and S Corporations – An Update on Pending Legislation* (June 18, 2010) at http://www.staleylaw.com/images/Carried Interest - 17074.pdf. *Note*: This proposal re-surfaced in the July, 2011 debates about extending the federal debt limit and deficit reduction.

[5] H.R. 4213; see my outline *LLCs and S Corporations – An Update on Pending Legislation* (June 18, 2010) at http://www.staleylaw.com/images/Carried Interest - 17074.pdf.

- This was part of the carried interest proposal (and included in proposed new IRC Section 710), but was not limited to partnership interests.

- Would also be subject to the 40% penalty on underpayments.

1.5. **Not enacted: Section 83 and partnership interests**[6]

- A method for valuing a partnership interest for Section 83 purposes was proposed.

- A deemed Section 83(b) election was proposed for transfers of partnership interests subject to Section 83.

1.6. **Not Enacted: Social Security Taxes for Professional Firms**[7]

- For a "disqualified S corporation," all of the flow-through income under IRC Section 1366 is treated as income from self-employment -- to certain shareholders.

    - Whose flow-through income? Each shareholder who provides substantial services (not necessarily professional) "with respect to" the "professional services business."

    - AND Each of his family members who do not provide substantial services to the "professional services business."

- Dividends would continue to be excluded from "self-employment income."[8]

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[6] H.R. 4213; see my outline *LLCs and S Corporations – An Update on Pending Legislation* (June 18, 2010) at http://www.staleylaw.com/images/Carried Interest - 17074.pdf.

[7] Section 413 of the American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213), amending IRC Section 1402 and Section 211 of the Social Security Act – *not enacted*.

[8] I.R.C. § 1402(a)(2). So this income would not be subject to this tax twice.

- Would have applied to:

    - An S corporation that engaged in a "professional service business" AND the business was principally based on the reputation and skill of 3 or fewer individuals, or

    - An S corporation that was a partner in a "professional service business."

- Would have removed the self-employment tax exclusion for limited partners if they provided "substantial services with respect to" a "professional services business" in which the limited partnership engaged. (Not limited to limited partners that are S corporations.)

- The definition of a "professional service business" would have been broader that for a cash method business (listed in IRC Section 448) and would have included lobbying, athletics, investment advice or management and brokerage services.[9]

    - Would have also included services in the fields of health, law, engineering, architecture accounting, actuarial science, performing arts and consulting, all of which are allowed to use the cash method.

    - Would not be as broad as a "personal service corporation," though.[10]

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[9] It would have been also broader than the definition of a "professional service corporation" in Treas. Reg. § 1.414(m)-1(c) ("certified or other public accountants, actuaries, architects, attorneys, chiropodists, chiropractors, medical doctors, dentists, professional engineers, optometrists, osteopaths, podiatrists, psychologists, and veterinarians").

[10] A "personal service corporation" has as its principal activity the performance of services and substantially all of those services are performed by employee-owners. I.R.C. § 269A(b)(1). The IRS can reallocate income between an PSC and its employee-owner just as it can between related businesses under IRC Section 482. I.R.C. § 269A(a).

- Revenue estimate: $11.2 billion over 10 years.[11]

- Status: Passed the House in mid-2010, failed a cloture vote in the Senate in June, 2010.[12] *Not enacted*.

2. Adequate Compensation of S Corp Shareholder-Employees

2.1. FICA and Medicare taxes

- All wages are subject to FICA tax and Medicare tax.[13] This includes wages paid to shareholder-employees of S corporations.

- Income flowing through an S corporation is not self-employment income subject to self-employment income tax.[14]

- Generally, amounts distributed to shareholders from a corporation are not subject to the FICA, Medicare or self-employment taxes.[15]

2.2. S corporation flow-through income

- Income that flows through an S corp to its shareholders retains its character (as ordinary income or capital gain, etc.)

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[11] JCT estimate. Daily Tax Report (BNA) 5-24-10, 98 DTR G-8.

[12] The bill included an extension of unemployment benefits without any offsetting revenue raiser or spending cuts, which was the main reason the bill failed the cloture vote.

[13] I.R.C. §§ 3101(a) (tax on employees), 3111(b)(6) (tax on employers).

[14] Rev. Rul. 59-221, 1959-1 C.B. 225 (predates the 1982 S Corporation Act, but should still apply).

[15] I.R.C. §§ 1402(a)(2) (dividends), 3121(a) (defining "wages"); *see generally* J. Eustice & J. Kuntz, FEDERAL INCOME TAXATION OF S CORPORATIONS, ¶ 11.02. This assumes, in the case of an S corporation, that the corporation pays a reasonable amount of wages for any services actually rendered by the shareholders to the corporation, as discussed below.

and is taxed to the shareholders at the tax rates for individuals.[16] This is true for federal and California tax purposes.

- Wages are deductible under Section 162 of the Internal Revenue Code.

- The income of an S corporation is subject to a 1.5% California franchise tax, which is deductible by the shareholders for federal tax purposes.

- So cash flow of an S corp that it transferred to a shareholder as a dividend rather than wages is subject to corporate-level California tax at an effective rate of approximately 1%, taking into account the federal deduction.

2.3. **Cases and rulings (all S corps)**

2.3(a) **1974 Revenue Ruling:** Dividends paid to employees who drew no salary were "wages" subject to withholding and employment taxes.[17]

- Facts: "[T]he shareholders performed services for the corporation. However, *to avoid the payment of Federal employment taxes*, they drew no salary from the corporation but arranged for the corporation to pay them 'dividends' of 100x dollars, which is the amount they would have otherwise received as reasonable compensation for services performed."

- Holding: "[T]he 'dividends' paid to the shareholders … were in lieu of reasonable compensation for their services. Accordingly, the 100x dollars paid to each of the shareholders was reasonable compensation for services performed by him, rather than a distribution

[16] I.R.C. §§ 1366.

[17] Rev. Rul. 74-44, 1974-1 CB 287 (predates the 1982 S Corporation Act, but has been affirmed by the cases below).

of the corporation's earnings and profits. Such compensation was 'wages' …."

- Not a huge deal until 1986, because S corps generally became C corps when they became profitable, and the lowest C corp rates provided a bigger tax benefit than avoiding FICA tax. It was easy for C corps to avoid a double tax then.

- In 1986 the double tax became hard to escape and the waiting period to avoid built-in gain was extended from three to ten years. The maximum tax rate for individuals was less than the maximum corporate tax rate. So C corps converted to S corps and S corps retained that status after they became profitable.

2.3(b) **Ulrich (1988)**: An officer who renders substantial services is an employee.

- Facts: Sole shareholder of accounting corporation was also the sole director and officer of the corporation. All the shareholder's income was dividends from the corporation.

- Holding: "Under both the weight of the case law and under the treasury regulations, a corporate officer is to be treated as an employee if he renders more than minor services." Court refused to stop the IRS from proceeding with collection efforts for FICA and FUTA taxes.[18]

2.3(c) **Radtke (1990)**: Dividends paid to sole shareholder who was also sole employee of his professional corp were really wages.

- Facts: Lawyer was sole shareholder and sole full-time employee of his professional corp. Took no

[18] Ulrich v. U.S., 692 F. Supp. 1053 (D. Minn. 1988).

compensation, only dividends. IRS assessed deficiencies for failing to pay FICA and FUTA taxes.

- Held: "We agree with the district court that the payments to this employee … constituted wages subject to FICA and FUTA contributions. FICA and FUTA broadly define 'wages' as 'all remuneration for employment' and the Treasury regulations are similarly broad."[19]

2.3(d) **Spicer Accounting (1990)**: The Ninth Circuit agreed with the 1974 Revenue Ruling and the Seventh Circuit, at least that "a corporation's sole full-time worker must be treated as an employee." [20]

- Facts: Idaho accountant was the only accountant working at his firm, working an average of 36 hours per week. He worked properties in the office on his rental properties 10%-15% of that time. Accountant and his wife each owned 50% of the stock. Accountant was president, treasurer and a director of the corporation. Accountant never took any salary, only dividends. Said he "donated" his services to the corporation.

- Law: "The Federal Insurance Contributions Act and Federal Unemployment Tax Act both define 'wages' as 'all remuneration for employment.' Treasury Regulations on Employment Taxes and Collection of Income at Tax Source … provide that *the form of payment is immaterial*, the only relevant factor being whether the payments were actually received as compensation for employment."[21]

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[19] Radtke V. U.S., 895 F.2d 1196 (7th Cir. 1990) (per curiam).

[20] Spicer Accounting v. U.S., 918 F.2d 90 (1990). The District Court case was not published.

[21] *Id.*, citing Treas. Reg. §§ 31.3121(a)-1(b) and 31.3306(b)-1(b) (emphasis added).

- Holding 1 – The dividends were wages: "[T]hese 'dividends' were in reality remuneration for employment and therefore subject to FICA and FUT."

- Holding 2 – He was not an independent contractor of the corporation: "We find that Mr. Spicer is not a common law independent contractor, because [the corporation] provided him with supplies and a place to work, and he performed accounting services for no other accounting firm. Moreover, Mr. Spicer's services were integral to the operation of [the corporation], as he was the only accountant in the accounting concern, the only one who signed customers' returns as preparer, the only one who performed financial planning for the firm, and the only one who audited clients' books."[22]

- Holding 3 – Section 530[23] relief was not available: "Mr. Spicer does not qualify for relief pursuant to this statute because the taxpayer 'had no reasonable basis for not treating him as an employee.' True, as this court has observed, 'reasonable basis' is to be 'construed liberally in favor of taxpayers.'" … Still, it is clear that Mr. Spicer failed to satisfy this standard, however liberally construed."

2.3(e) **Dunn & Clark** (1994): Two shareholders.

- Facts: Two lawyers, zero salary.

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[22] *Ulrich* and later cases did not use the "independent contractor or employee" analysis for officers. The courts accepted the statement in the regulations that if an officer of a corporation renders more than minor services to the corporation, the officer is an employee of the corporation. So the factual issue was whether the officer rendered more than minor services. Compare the *Veterinary Surgical Consultants* case, below..

[23] Generally, Section 530 of the Revenue Act of 1978 would have applied if the taxpayer consistently and reasonably treated the service provider as an independent contractor. If Section 530 had applied, the Service would have been required to accept that treatment for past years.

- Holding: "To reach the conclusion that the payments were dividends would require the court to accept that Dunn and Clark were providing legal services on behalf of the corporation's...clients out of the goodness of their hearts without regard to receiving payment for their legal services."[24]

2.3(f) **Boles Trucking v. U.S (1994)**: Loans not distributions. Many other employees, though they were wrongly treated as independent contractors.[25]

- Facts: Sole source of sole shareholder and president's income for three years at issue was "loans against future profits" from the corporation. The corporation also paid personal expenses and provided a car.

- Holding 1 – Loans were wages: "While [the president] would have the Court find no salary or wage were paid to [him], the Court finds this is not reasonable, and that [those] amounts … represent the wages to plaintiff upon which FICA and FUTA taxes should be paid."

- Holding 2 – Penalties were properly imposed: "While a taxpayer may establish reasonable cause (and/or lack of willful neglect) by showing that it reasonably relied on the advice of an accountant or tax preparer…, ordinary business care and prudence on the part of the taxpayer are still required. Obviously, reliance on the advice of others must be reasonable to make out a showing of reasonable cause. Boles received no income other than that received from the taxpayer. For the years in question, Boles was running a corporation with no employees for

[24] Dunn & Clark v. Comm'r, 853 F. Supp. 365 (D. Idaho 1994), *aff'd without published opinion*, 75 AFTR2d 95-2714, 95-2 USTC ¶50,383 (9th Cir. 1995).

[25] Boles Trucking v. U.S., 879 F. Supp. 1019 (D.C. Neb. 1994), *aff'd on this issue*, 77 F.3d 236 (8th Cir. 1996).

federal tax purposes. Under the facts of this case, … taxpayer failed to meet its burden of showing reasonable cause."

2.3(g) **Davis v. U.S. (1994)**: Taxpayer wins with part-time involvement.[26]

- Facts: Corporation operated a "lime slurry brokerage business in Colorado and Utah." Owned by husband and wife, both officers. Husband was employed elsewhere and was not involved in this business. Wife performed part-time clerical duties for the corporation, including paying bills, submitting invoices, making bank deposits, communicating with independent contractor truck drivers, making business decisions. She took a few business trips on the corporation's business. She said she spent 12 hours per month on the business. Her accountant said her services were worth $8 per hour. *The IRS did not challenge the time commitment or the value of the time*. The IRS wanted $39,000.

- Held: The court accepted her time estimate and her accountant's estimate of the value of her services. The court reduced the assessment to $647. *The taxpayer won because the government did not introduce any evidence to challenge her time commitment or the value of her time*.[27] The court also awarded the taxpayer her litigation costs of $36,000.

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[26] Davis V. U.S., 1994 U.S. Dist. LEXIS 10725, 74 A.F.T.R.2d (RIA) 5618 (D.C. Colo. 1994) and 887 F. Supp. 1387, 95-2 USTC 50,374 (regarding litigation costs) and 1995 U.S. Dist. LEXIS 4397 (litigation costs quantified).

[27] Compare the 2006 case *JD &Associates*, described below, in which the government introduced detailed evidence, shifting the burden of proof to the taxpayer.

2.3(h) **Van Camp & Bennion (1996)**: Semi-retired officer and 40% shareholder was *not* an employee. Contingency fee lawyer with a 60% interest *was* an employee.[28]

- Held: "Given his age, semi-retirement status and the limited extent of his legal practice at that time, the court concludes [the corporation] met its burden of proof as to independent contractor status with respect to [the 40% shareholder]. The court finds credible his assertions his administrative services on behalf of the corporation were minimal, limited to a short annual meeting and substituting for [the 60% shareholder] when he was unavailable." The 40% shareholder did church work at the office, too. The 60% shareholder owned the building and an airplane.

2.3(i) **Joly (1998)**: Less than all dividends recharacterized as compensation.[29]

- Facts: Founder of custom home builder held 70% of the stock. A son held 30%. Founder and son were officers but took zero compensation. Each rendered substantial services to the corporation. Corp paid the personal expenses of family members. The corp and each shareholder had a written agreement "that the sole compensation for his services would be his share of the corporation's profits. Under the agreement, [the shareholder] was permitted to withdraw monetary advances of anticipated profits. The advances were to be treated as a loan on the corporation's books to the extent they exceeded the corporation's profits." There was no documentation for loan treatment. No shareholder loans were shown on the balance sheets in the tax returns.

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[28] Van Camp & Bennion v. U.S., 96-2 USTC (CCH) ¶50,438 (E.D. WA 1996) (magistrate judge). This is a C corporation.

[29] Joly v. Comm'r, 76 TCM 633 (1998), *aff'd in an unpublished opinion* 211 F.3d 1269, 2001-1 USTC ¶50,315 (6th Cir. 2000).

- Holding 1 – The IRS determination of the amount of wages is presumed by the Tax Court to be correct. The taxpayer has the burden to prove that the IRS is not correct.

- Holding 2 – "[T]he characterization in the … agreements of the amounts paid to or on behalf of [the father and son] do not reflect the true character of such payments."

- Holding 3 – To decide the reasonableness of compensation, consider 9 factors:

  (1) The employee's qualifications;

  (2) The nature, extent, and scope of the employee's work;

  (3) The size and complexities of the employer's business;

  (4) Compare the salaries paid with the employer's gross and net income;

  (5) The prevailing general economic conditions;

  (6) Compare salaries paid with distributions of retained earnings;

  (7) The prevailing rates of compensation for comparable positions in comparable concerns;

  (8) The salary policy of the employer as to all employees; and

  (9) In the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years.

- Holding 4 – The Court upheld the IRS reclassification of most of the dividends as wages, based on a review of the corporation's bank statements:

Year	Father/Founder			Son/VP	
	Dividends before change	**Held to be wages**		**Dividends before change**	**Held to be wages**
1992	$83,000	$46,000		$-0-	
1993	$99,000	$86,000		$19,000	$17,000
1994	$65,000	$61,000		$23,000	$23,000

2.3(j) **Veterinary Surgical Consultants (2001)**: Part-time work, but the shareholder did all of the work that was done for the loan-out S corporation.[30]

- Facts: Doctor was a full-time employee of Bristol-Myers Squibb. Doctor spent 33 hours per week on the business of his S corporation, which loaned out his consulting and surgical services to a veterinary hospital. All income of the S corporation was from the services of the doctor. "[The doctor] is the only person with signature authority on [the S corporation's] bank account. [The doctor] handled all of petitioner's correspondence and performed all administrative tasks on behalf of [the S corporation]. [The S corporation] did not make regular payments to [the doctor]; rather, [the doctor] withdrew money from [the S corporation's] bank account at his discretion."

[30] Veterinary Surgical Consultants v. Comm'r, 117 T.C. 141 (2001), *aff'd in an unpublished opinion*, Yeagle Drywall, 2003-1 USTC (CCH) ¶50,141 (3d 2002), *cert. denied*, 538 U.S. 943 (2003). The same doctor lost in Tax Court on the same issues for the same S corporation for two later years. Veterinary Surgical Consultants v. Comm'r, 85 TCM 901 (2003), *aff'd in an unpublished opinion*, 2004-1 USTC (CCH) ¶50,209 (3d Cir. 2004).

- Holding 1: "[The doctor was] an employee of [the S corporation] and, as such, the payments to him from [the S corporation] constitute wages subject to Federal employment taxes."

- Holding 2 – If an officer performs more than "minor services" for the corporation, it is not necessary for FICA purposes to determine whether the officer is also a common law employee.[31]

2.3(k) **JD & Associates (2006)**: IRS used comparables and the Court accepted them.[32]

- Facts: Accountant (an EY alum) and sole shareholder took low salary and big dividends. The government showed by comparables that the salary was too low and what it should be.[33]

- Holding: The court distilled the 9-factor test to three factors and accepted the government's position. The Court noted that the principal's salary was less than one of the two employee's salary in 1997 and just over the salaries of the other three employees in 1998 and 1999. Here's how the Court came out:

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[31] Compare the *Spicer* case, in which the Ninth Circuit went through the "independent contractor vs. employee" analysis.

[32] JD & Associates v. U.S., No. 3:04-cv-59 (D.C.N.D. May 19, 2006) (referenced in the *Watson* case, below, and found by a Google search for the name and case number.

[33] The evidence was offered by a valuation engineer with the IRS who was an Accredited Valuation Analyst. The Court was most impressed with the Risk Management Associates national survey because it compared accounting firms of similar revenues. The Court liked the comparison of officers salary to firm profitability and salary as a percentage of net sales. The Court thought that this was a good alternative to comparing the salary of this Fargo, North Dakota accountant to "raw salaries of accounting executives in New York, Chicago and Los Angeles." The engineer also offered data from Leo Tory's Almanac of Financial Ratios and from Job Service of North Dakota, but the Court did not rely on it. Compare the *Davis* case, above, in which the government offered not evidence to contradict the taxpayer's evidence.

Year	Salary	Distribution	Total	Salary per Court
1997	$19,000	$47,000	$66,000	$62,000
1998	$30,000	$50,000	$80,000	$64,000
1999	$30,0000	$50,000	$80,000	$66,000

2.3(l) **Watson (2010)**: Loan-out corp. Too cute, too little.[34]

- Facts: Sole shareholder had a masters degree in tax and was an EY alum. Four-partner accounting firm, each partner incorporated an S corp. By a shareholder's resolution, he set his annual salary at $24,000 for his full-time services. The PC distributed more than $200,000 annually. *The salary amount was less than shareholder's living expenses*. "In selecting $24,000.00 as his salary, Watson did no research other than to talk to [his partners] to reach an agreement on what salary each would pay himself."

- Argued: Shareholders argued that the shareholder's resolution prevented the IRS from treating any of the distributions as wages.

- Held: The resolution to pay annual salary of $24,000 did not prevent the IRS from asserting that some or all of the distributions were wages for FICA purposes.[35]

- *Note*: Setting a salary that covers the shareholder's living expenses is probably a good idea if the S corporation is the primary source of cash flow for the shareholder-employee.

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[34] Watson v. U.S., 714 F. Supp. 2d 954 (D.C. Iowa 2010).

[35] This was the only issue in controversy at this early stage of the case.

2.4. The View from Washington, D.C.

2.4(a) 2002 Report of the Treasury Inspector General for Tax Administration[36]

- Reviewed a sample of 84 S corporation returns. In this sample, the average shareholder-employee wage was $5,300 and the average total distribution was $349,000.

- Recommended that the IRS improve data gathering and better educate its field personnel.

- IRS Response: Yeah, we know. We can't gather the data to enforce this very well.[37]

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[36] Treasury Inspector General for Tax Administration, THE INTERNAL REVENUE SERVICE DOES NOT ALWAYS ADDRESS SUBCHAPTER S CORPORATION OFFICER COMPENSATION DURING EXAMINATIONS. REFERENCE NUMBER 2002-30-125 (July 5, 2002), available on the agency's website as http://www.treasury.gov/tigta/auditreports/2002reports/200230125_mgmt_resp.pdf.

[37] Here's what the IRS actually said in its "Management Response":

> We agree a non-compliant segment of the S Corp population avoids FICA taxes by compensating officers with distributions and loans rather than salaries. Because of the decline in available enforcement resources, we believe we can best address this issue with a balanced approach that includes limited enforcement activity and expanded educational outreach. We will continue to enhance the technical guidance we offer classification and field personnel on this issue through CPE and web-based information. We will advertise the availability of software that the IRS owns to aid examiners in making reasonable compensation determinations. Transcribing additional return line items and measuring examination results can help focus our examination and educational resources on noncompliant taxpayers. We are requesting changes, but all changes must compete with other priorities for resources. Resources for additional transcription of return line items are particularly difficult to secure.
>
> Because we cannot capture Form 1120S data electronically, we cannot identify the IOC [inadequate officer compensation] issue without a

2.4(b) 2005 Joint Tax Committee Report

- In effect: If we can't enforce the laws we have, let's adopt laws that we can better enforce.[38]

- Proposal: For shareholders who materially participate in the business, subject all the flow-through in-

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(..continued)

time-consuming, costly physical review of returns broadly identified as potentially non-compliant.

C. Rossotti, Memorandum for Treasury Inspector General for Tax Administration, August 12, 2002, on the TIGTA website as http://www.treasury.gov/tigta/auditreports/2002reports/200230126_mgmt_resp.pdf.

[38] Staff of the Joint Committee on Taxation, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, No. JCS-02-05 (January 27, 2005 (in response to a request by the Senate Finance Committee) (available on http://www.jct.gov):

> It has become increasingly common for individuals who perform services in businesses that they own to choose the S corporation form to seek to reduce their FICA taxes. S corporation shareholders may pay themselves wages below the wage cap, while treating the rest of their compensation as a distribution by the S corporation in their capacity as shareholders. They may take the position that no part of the S corporation distribution to them as shareholders is subject to FICA tax. While present law provides that the entire amount of an S corporation shareholder's reasonable compensation is subject to FICA tax in this situation, enforcement of this rule by the government may be difficult because it involves factual determinations on a case-by-case basis. [Page 99].
>
> Disparate treatment of wages and other distributions under present law [as compared to partnerships] creates an undesirable incentive for individuals performing services to avoid FICA tax on labor income, including on the uncapped HI component, by setting up business as an S corporation and characterizing as wages a small amount of service income below the wage cap, while the rest is passed through the S corporation to the shareholder-employee free of FICA tax. [Page 103.]

come to self-employment tax. If a shareholder does not materially participate, keep the current rules.[39]

- The JCT made the same proposal for partnerships and LLCs.

- Revenue estimate: $57 billion over nine years.

2.5. **Other S corporation distribution issues**

2.5(a) C corporation => S corp - float the salary down, don't radically reduce it in the first S corporation year.

2.5(b) Consider whether the distribution is tax-free under Section 1368.

2.5(c) Distributing borrowed funds will often trigger gain because the distribution exceeds shareholder's basis in his shares. This is because the corporate-level borrowing

[39] Here what the JCT said:

> Under the proposal, for purposes of employment tax, an S corporation is treated as a partnership and any shareholders of the S corporation are treated as general partners. Thus, S corporation shareholders are subject to self-employment tax on their shares of S corporation net income (whether or not distributed) or loss. As under the present-law self-employment tax rules, specified types of income or loss are excluded from net earnings from self-employment of a shareholder, such as certain rental income, dividends and interest, certain gains, and other items. However, under the proposal, in the case of a service business, all of the shareholder's net income from the S corporation is treated as net earnings from self-employment. A service S corporation is one, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to sec. 448(d)(2)).
>
> If a shareholder does not materially participate in the trade or business activity of the S corporation, a special rule provides that only reasonable compensation from the S corporation is treated as net earnings from self-employment. [Page 100.]

does not create basis. Also, borrowed funds must be repaid with after-tax dollars.

2.5(d) There are corporate law limits on distributions, which kick in if more than the retained earnings will be distributed.[40]

2.5(e) Distributions cannot be a basis for a qualified plan contribution.

2.5(f) The government has successfully argued inadequate compensation to deny social security benefits, too.

2.5(g) For a corp with a shaky S corporation status, consider salary and not distributions, because the distributions will not be deductible if the corp is really a C corporation.

2.5(h) It is still possible to have disproportionate distributions create a second class of stock and terminate the S corporation status. It requires an agreement to make the disproportionate distributions, but the IRS might be able to prove that from a course of conduct.[41]

[End of outline.]

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[40] Chapter 5 of the General Corporation Law, Cal. Corp. Code § 500 et. seq. for California corporations.

[41] Treas. Reg. § 1.1361-1(*l*).