

## Dividend distributions by S corporations save on FICA taxes

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This Practice Alert (excerpted from a more extensive article in the December 2005 issue of Practical Tax Strategies Practical Tax Strategies ¶ 12200509 ) explains how S corporations and their shareholder-employees can save on employment taxes by characterizing more distributions as dividends rather than as compensation for services, the government's initiatives in this area, and how to help prevent a challenge from IRS.

**Owner/employees.** Owners of a closely held C corporation can enjoy a significant benefit from paying a shareholder/employee as much as possible in the form of salary (rather than dividends) in order to minimize the double tax. This strategy, however, is not applicable to a limited liability company (LLC) or an S corporation because these entities generally do not pay an entity-level income tax. To the contrary, an S corporation shareholder/officer benefits from having distributions classified as dividends. This is because a salary, unlike a dividend, is subject to federal employment taxes (i.e., FICA and FUTA).

Classifying a distribution as a dividend can also be beneficial for a shareholder/officer of an S corporation who retires before "normal" retirement age (i.e., 65 years and six months in 2005). Dividends, unlike salary for services rendered, do not reduce an individual's Social Security benefits.

**Historical perspective.** IRS first addressed the issue of dividends versus salaries received by shareholder/employees of an S corporation in '74. In [Rev Rul 74-44, 1974-1 CB 287](#), it concluded that dividends received by the two sole shareholders of an S corporation were, in fact, "wages" for services rendered for which the corporation was liable for FICA and FUTA as well as the withholding of income tax.

In the 1980s, two district courts concluded that an officer of an S corporation was an employee for employment tax purposes. Both decisions were appealed to the Seventh and Ninth Circuit Courts of Appeal, which affirmed the lower courts' decisions.

**Nu-Look Design, Inc.** The two cases discussed above both involved S corporations that provided professional services (i.e., legal and accountancy) to the firm's clients. In 2003, IRS in *Nu-Look Design, Inc.*, [93 AFTR 2d 2004-608](#), 356 F3d 290, 2004-1 USTC 50138 (CA-3, 2004), again looked at payments from an S corporation to its sole shareholder/officer. Again, the issue to be resolved was whether the payments should be classified as dividends or wages for services rendered. This time, however, the S corporation did not provide professional services but rather was in the home improvement business.

**Contention regarding S corporation shareholders.** Citing [Code Sec. 1366](#) and [Code Sec. 6037\(c\)](#), Nu-Look argued that S corporation shareholders should not be deemed employees. The Tax Court we rejected any suggestion that Nu-Look's passing through of its net income to its sole shareholder/officer precludes the finding of an employer-employee relationship.

In conclusion, the Tax Court found that Nu-Look's sole shareholder/officer performed "more than minor services for Nu-Look and that he had received remuneration for those services." As a result, the court held that he was an employee of Nu-Look under [Code Sec. 3121\(d\)](#); therefore, it was liable for employment taxes for '96, '97, and '98. The Third Circuit affirmed.

**IRS guidance.** In a memorandum dated July 5, 2002 and entitled "The Internal Revenue Service Does Not Always Address Subchapter S Corporation Officer Compensation During Examinations," IRS outlined four recommendations designed to remedy this issue. Two of these recommendations are summarized below:

- (1) The Director, Compliance, Small Business/Self-Employed Division should provide technical guidance and resources (such as software) to field personnel to aid in determining reasonable officer compensation.
- (2) The Director, Taxpayer Education and Communication, Small Business/Self-Employed Division should develop consistent materials for educating and informing taxpayers and representatives of their S corporation officer compensation tax obligations. Such materials could include sending out

pre-filing literature to taxpayers electing S corporation status.

An example of the latter recommendation has already surfaced. IRS is now including additional information (some might say a "warning") on acceptance of the S corporation election on Form 2553. The following notice was dated Jan. 10, 2005: Notice of Acceptance as an S-Corporation:

We have accepted your election to be treated as an S corporation with an accounting period of December beginning Nov. 1, 2004.

We would also like to take this opportunity to inform you of your tax obligations related to the payment of compensation to shareholder-employees of S-corporations.

When a shareholder-employee of an S corporation provides services to the S corporation, reasonable compensation generally needs to be paid. This compensation is subject to employment taxes.

Tax practitioners and Subchapter S shareholders need to be aware that [Rev Rul 77-44](#) states that the IRS will re-characterize small business corporation dividends paid to shareholders as salary when such dividends are paid to the shareholders in lieu of reasonable compensation for services.

**Recent Treasury statement** On Aug. 5, 2005, the Treasury Inspector General for Tax Administration presented a report before the Senate Finance Committee regarding IRS's administration of certain employment tax laws. The report found that employment tax inequities exist between sole proprietorships and single-shareholder S corporations.

Specific conclusions of the report include the following:

(1) In Tax Year 2000, 78.9% of all S corporations were either fully owned by a single shareholder, or more-than-50% owned by a single shareholder. Therefore, in nearly 80% of S corporations, the individual who owns the business determines the salary paid to the shareholder operating the business.

(2) The S corporation form of ownership has become a multibillion dollar employment tax loophole for single-shareholder businesses. In Tax Year 2000, the owners of 36,000 single-shareholder S corporations received no salaries at all from their corporations, even though the operating profits of each of these corporations exceeded \$100,000. This resulted in employment taxes not being paid on \$13.2 billion in profits.

(3) The owners of single-shareholder S corporations have been setting their salaries at a decreasing percentage of corporate profits in the past several years. In Tax Year '94, these shareholders paid themselves salaries subject to employment taxes equal to 47.1% of their profits. This percentage fell to 41.5% by Tax Year 2001. In comparison, sole proprietors pay employment taxes on all their operating profits.

(4) In Tax Year 2000 alone, S corporations paid \$5.7 billion less in employment taxes than would have been paid if the taxpayers were sole proprietors.

(5) Advising small businesses to save on employment taxes by forming S corporations has become a cottage industry. A search of the Internet yields many sites that advise entrepreneurs that they can save thousands of dollars a year in employment taxes simply by incorporating.

**Conclusion.** S corporations and their shareholder/employees have an employment tax incentive to distribute corporate earnings as dividends rather than as compensation to the shareholder employees. As IRS releases and court decisions indicate, however, IRS may scrutinize how an S corporation classifies its distributions, revise the classifications, and assess additional tax accordingly. With proper planning, however, an S corporation's compensation policy has a better chance of lowering its ultimate out-of-pocket employment tax costs.

**Planning tip.** The following actions could help in preventing the IRS from declaring that dividends distributed by an S corporation to a shareholder/employee should be treated as compensation and subject to withholding and employment taxes:

... Develop a salary or wage policy (e.g., per month or per hour) and compensate the shareholder/employee in accordance with the policy.

... Consider the following nonexhaustive list of factors when setting compensation in order to maintain reasonable levels of compensation:

- ... Employee qualifications.
- ... Nature, extent, and scope of work performed.

- ... Nature and size of business.
  - ... Comparison of salaries with financial results.
  - ... Compensation paid for similar work in comparable companies.
  - ... Document the above elements in the corporate minutes.
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