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## Wage Taxes and Compensating S Corporation Officers and Members of LLCs and LLPs

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# **SOCIAL SECURITY SCOFFLAWS ALCHEMIZE SALARY INTO EARNINGS**

## **I. Scope of S Corporation Executive Under Compensation**

- A. 3,341,606 S Corporations for 2003 (latest Statistics of Income)<sup>1</sup>
- B. In 2006, 60% of S corporations had a single shareholder; 89%, two or fewer shareholders, and 94%, three or fewer shareholders.<sup>2</sup>
- C. For 2003 and 2004 combined GAO, based upon S Corporation National Research Program (NRP) samples, estimates 887,000 S Corporations misreported shareholder compensation in the aggregate amount of \$23.6 billion; 15% of all 1 shareholder S corporations misreported shareholder compensation; 10% of 2-3 shareholder S corporations misreported shareholder compensation thus underreporting wage taxes.<sup>3</sup>
- D. The wage tax gap as to such closely held S corporations providing professional services is around \$1 billion a year. This is around 18% of the wage tax gap for all S corporations.<sup>4</sup>
- E. "The IRS should pursue the following additional issues in the NRP program. The self-employment aspect of S-corporations is a very common planning issue, likely to be associated with noncompliance." Tax Gap Analysis Subgroup Report (2008 IRSAC Report)

## **II. Government Studies and National Research Audits of S Corporation Executive Under Compensation**

### **A. NRP Wage Tax Audits**

- i. In February 2011 Janine Cook, branch 1 chief (employment tax), IRS Tax-Exempt and Government Entities Division, stated that 2,000 audits in the first phase of the National Research Program had been under way for nearly a year and IRS was looking forward to analyzing the information gleaned from the program in order to more accurately pinpoint the causes of the tax gap. The **NRP Wage Tax Audits program**, which is in effect from 2010 through 2012, will include 6,000 comprehensive audits of large and small businesses, as well as tax-exempt organizations, regarding **payroll taxes, fringe benefits, reimbursed expenses, executive compensation, and worker classifications**. Marie Sapirie, *IRS Considering Formal Process for Worker Misclassification Closing Agreements*, 130 Tax Notes 1002 (Feb. 28, 2011); Sam Young, *Official Fleshes Out Details On Payroll Research Project*, 2011 TNT 10-5 (Jan 14, 2011)(randomly select 2,000 taxpayers per year for three or more years; no results from NRP will be announced until all examinations have ended; payroll issues contribute more than \$70 billion to the annual tax gap, approximately twice as much as corporate tax issues); Sam Young, *IRS Officials Discuss Payroll Tax Research Initiatives*, 2010 TNT 88-6 (May 7, 2011)("What we're

<sup>1</sup> Kelly Luttrell, S Corporation Returns, 2003, 25 STATISTICS OF INCOME (SOI) BULLETIN 94 (2005), available at <http://www.irs.gov/pub/irs-soi/03scorp.pdf>; Joint Committee on Taxation Staff, Tax June 4, 2008)("Small Business and Choice of Entity").

<sup>2</sup> Government Accountability Office, *Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules 4* (GAO-10-195 Dec. 9, 2009)("Noncompliance with S Corporation Tax Rules").

<sup>3</sup> *Noncompliance with S Corporation Tax Rules*, supra note 2 at 13 Table 4 and 11 Table 2.

<sup>4</sup> *Id.* at 10-11 and Table 2.

calling a three-year study will probably take longer than three years.” Examinations of payroll returns will be comprehensive and address worker classification, fringe benefits, *executive compensation*, and tip reporting. Employers subject to the study include taxpayers under the purview of SB/SE, the Large and Midsize Business Division, and the Tax-Exempt and Government Entities Division); TIGTA, *Limitations in the Sample Size for the Internal Revenue Service’s Employment Tax Study May Impact the Ability to Determine Compliance Levels 3, 4* (2011-10-034 May 17, 2010 Final Report on May 17, 2011)( IRS selected the sample of employers to include in the Study based on available resources; audit results for the sampled taxpayers may not enable IRS management to fully estimate compliance levels for business taxpayers; IRS management indicated that additional audits may be required after the Study is completed to improve the IRS’s estimates of business taxpayers’ reporting compliance). “[T]he IRS research team keeps track of trends in all tax areas. If they see a trend developing over a period of a year or two, a division might be asked to examine the returns through an audit, said Anita Bartels, program manager for IRS’s employment tax compliance policy.” Liz White, *IRS Continues to Keep Close Watch on Audit Program for Insight Into Tax Gap*, 121 DTR G-3 (6/23/2011).

- ii. TIGTA, *Limitations in the Sample Size for the Internal Revenue Service’s Employment Tax Study May Impact the Ability to Determine Compliance Levels 5, 3*: (2011-11-034 May 17, 2010):

	Size	Percent of 2008 Sample
SB/SE Small Business/Self-Employed	1,500	68.97%
TE/GE Tax Exempt Organizations <sup>12</sup>	535	24.60%
TE/GE Government Entities <sup>13</sup>	9014	4.14%
LB&I Large Business & International	50	2.30%
<b>Total</b>	<b>2,175</b>	<b>100%</b>

For 2008 over 5.5 million small businesses with employees represented 90% of the total employer population and filed more than 85% of all employment tax returns, but large employers accounted for over 45% of the total United States payroll. IRS plans to sample only 50 large/international business taxpayers in each year of the Study, which may be too small of a sample to provide meaningful compliance estimates for these taxpayers.

**B. 2010 Proposed Service Entity Legislation**

- i. Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in the “American Jobs and Closing Tax Loopholes Act of 2010,” for consideration on the floor of the House of Representatives*, 289-93 (JCX-29-10 May 28, 2010). The bill as part of the “pay for” as to the Extenders, passed House in June 2010 but could not garner 51 votes in the Senate, would have treated pro rata share of income of service provider (and related parties) in a “disqualified S corporation” as self-employment income subject to SECA tax.

A “disqualified S corporation” was defined (1) an S corporation that is a partner in a partnership engaged in a professional service business if substantially all of the S corporation’s activities were performed in connection with the partnership, and (2) 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.**<sup>5</sup> An employee included an individual who is considered an employee for Federal tax purposes, i.e., an under-compensated professional S corporation shareholder-employee.

Under the provision, for SECA tax purposes, a shareholder's pro rata share of S corporation income or loss under §1366 attributable to the professional service business included the pro rata share of each member of that shareholder's family of such items of income or loss of the S corporation and would have treated as self-employment income. This rule applied if the family member does not provide substantial services with respect to the professional service business. For this purpose, family members are an individual's spouse, parents, children and grandchildren.<sup>6</sup>

As under the present-law self-employment tax rules in the case of a trade or business carried on by a partnership, certain items of income or loss would have been excluded from net earnings from self-employment of an S corporation shareholder under the provision, such as certain rental income, dividends and interest, and certain capital gains and losses.

**A professional service business for this purpose meant 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.** Significantly this limitation to "professional service business" omitted any other trade or business where the principal asset was the reputation, or skill of three or less of its employees.

Also the §1402(a)(13) exclusion from SECA for a limited partner's distributive share of partnership income or loss would not have applied to any partner who provided substantial services with respect to a professional service business in which the partnership is engaged.

1. On the Senate floor opponents to this provision criticized as to new terms such as substantially all and attribution to skills or reputation,<sup>7</sup> but the

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<sup>5</sup> This reputation and skill approach had its origin in Joint Committee, *Description and Analysis of Proposals Relating to Worker Classification and the Tax Treatment of Certain S Corporation Shareholders* 20 (JCX-6-94 May 2, 1994). The 1994 proposal noted that the common element to services firms "was that "the success of the business is dependent upon the skills of ... [the professional] individual rather than the application of capital." *Id.* That proposal defined "service-related business" as "any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal is the reputation, or skill of one or more of its employees."

<sup>6</sup> Assume an individual owns 4% of the stock of an S corporation, and provides substantial services with respect to a medical professional service business engaged in by a partnership in which the S corporation is a partner. The individual's spouse, who provides no services with respect to the business, owns the other 96% of the S corporation stock. Under the provision, the service-providing shareholder includes in net earnings from self-employment his own pro rata share, and also the spouse's pro rata share of items of income or loss under §1366 attributable to the professional service business.

<sup>7</sup> "[I]t will be very difficult to trace the hours of work for certain shareholders and link it back to the firm's revenues. Lawyers and CPAs can track their hours because that is how their businesses operate, but other service professionals such as engineers and architects do not.... also does not define what amount of participation in professional services activities determines if one must pay the new tax. The House version says 'substantially all.' The Senate version seems to suggest that even very limited participation in any of the activities listed under the new

- most extreme (and inaccurate) criticism was that the provision “unnecessarily treats the income of **4 million small businesses organized as S corps all as wages, which undermines the entire rationale for having flow-through entities: to avoid the double taxation of entrepreneur's income.**”<sup>8</sup> Actually for 2004, S corporation returns *all* services industry sectors without regard to number of shareholders filed 31.26 percent of all of S corporation returns (and held only 11 percent of all S corporation assets).<sup>9</sup>
2. Senator Max Baucus, D-Mont., then Senate Finance Committee Chair, explained that it was “attempting to stop the abuses of some professional S corps, the abuses they have been conducting. Frankly, they have been paying themselves a very small salary. These are professional corporations primarily. Then they pay themselves dividends. Because dividends are not wages, they avoid payroll taxes. They avoid the FICA tax and avoid paying the Medicare tax. That is something we are trying to stop. The substitute still addresses that abuse but in a way that is less burdensome to bona fide S corporations.”<sup>10</sup>
  3. An opponent declaimed: “My colleagues on the other side of the aisle call this a “loophole closer” or an “**anti-fraud provision.** . . . . None of us is in favor of fraud, but that is not really what we are talking about. If the IRS wants to improve compliance with the self-employment tax, they have the right tools. They just need to use them. For example, the *IRS Revenue Ruling 74-44* that specifically addresses the tax treatment of dividends in lieu of compensation gives them all they need. . . . . **I also have pages and pages of case law of which the IRS has successfully litigated the issue of dividends in lieu of compensation and the applicability of employment taxes.** Plus, Congress has codified the *economic substance doctrine which says a transaction must have an economic purpose aside from the reduction of tax liability in order to be considered valid.* In my opinion, this is the IRS's ace-in-the-hole card. The IRS can close any loophole-real or imagined-with the power of the new law.

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definition of professional services would be subjected to the tax . Is that the intention? Finally, the family attribution rules would appear to hit inactive family members who are solely shareholders and do not actively participate in the day-to-day operations of the business by subjecting their investment income to payroll taxes.” Remarks of Sen. Kyl, R-Az, 156 Cong Rec S 5419 (June 24, 2010).

<sup>8</sup> *Id.*

<sup>9</sup> TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, FILING CHARACTERISTICS AND EXAMINATION RESULTS FOR PARTNERSHIPS AND S CORPORATIONS 5 (2006-30-114 Aug. 28, 2006).

<sup>10</sup> 156 Cong Rec S 4972 (June 16, 2010). *See also Hearing before the Senate Finance Committee on Social Security: Achieving Sustainable Solvency*, S. Rep. No. 109-391, 109th Cong., 1<sup>st</sup> Sess. 30 (2005). In the May 2005 Senate Finance Committee Hearings, then Ranking Minority Member Senator Max Baucus, D-Mont., observed that “[i]t looks like that many S corporations, particularly controlled by one shareholder, or two, are avoiding salaries to avoid employment taxes. Why not correct that as part of the solution [to social security insolvency]?” *Id.* at 25. Senator Ron Wyden, D-Ore., was “very troubled by the fact that a substantial number of extremely wealthy people are not contributing their share on this Social Security matter. **They are what I call the Social Security scofflaws. That is what they are, Social Security scofflaws.** I think Senator Baucus was dead right that you ought to go after them first.” *Id.* at 29-30. (emphasis supplied).

**Why can't the IRS do its job with the volumes of legislative regulatory and judicial tools it already has?** For example, the IRS revenue ruling could be codified somehow, but then it wouldn't provide an offset for new programs, would it? Nor would it permit my colleagues across the aisle to reduce the tax on venture capitalists for their carried interest. I don't like the carried interest provision, but to soften the impact of that policy on the backs of small businesses is just plain wrong.

**Even the Government Accountability Office agrees the IRS should be doing more with what it has to crack down on fraud.** [emphasis added]

In a 2009 report, the GAO stated: "IRS efforts to enforce the rules on paying adequate wage compensation to small business shareholders have been limited," and the IRS provides only "limited guidance in determining adequate compensation" guidelines for taxpayers. A 2002 report by the Treasury's inspector general found that "IRS agents did not always address officer compensation, even when little or no compensation was paid." Clearly, the IRS isn't doing its job. That is the loophole. The IRS can and should do more with what they already have."<sup>11</sup>

4. Similarly the chief opponent, Senator Snowe, R-Me., argued "The provision is aimed, as I have been told, at a **specific abuse of the S corporations wrapped in a partnership, which is a business format that allows a business owner to inappropriately divert more money than is justified to nonsalary distributions that are not subject to payroll taxes.** Unfortunately, in order to prevent this specific abuse, the authors had to write a very expansive anti-abuse provision causing collateral damage to taxpayers who are not abusing the system and imposing payroll taxes on retained earnings on small businesses. This is a job killer, because retained earnings are the most reliable form of capital available to small businesses. While there have been clear abuses of existing law regarding reasonable compensation, it should be noted that the IRS successfully prosecutes cases where business owners inappropriately divert salary income to dividend distribution. In fact, the ruling as recent as May 27 of this year in *David E. Watson PC v. United States* proves that the "reasonable compensation" standard can be workable. Yet, it is not a clear bright line test that is either easy for the IRS to enforce or for taxpayers to understand. That is why I worked diligently, along with my staff, to find a way to address this abuse and agree that if we could find a way to improve upon and make clearer the "reasonable compensation" standard, we should do so."<sup>12</sup>
- ii. Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* (JCS-3-2011 June 2011). This professional services provision proposal was not included in President's 2012 Budget Proposals although companion revenue raiser as to Carried Interest is.
- iii. The bottom line is that a legislative cure is highly unlikely at the present time.

#### **C. 2009 Government Accountability Office Report**

- i. According to IRS data from the S Corporation NRP, about 68% of S corporation returns filed for tax years 2003 and 2004 (the years data were

<sup>11</sup> 156 Cong. Rec. S4972 (June 24, 2010)(Sen. Enzi, CPA); *id.* at S5240-41.

<sup>12</sup> *Id.* at S5417.



available) misreported at least one item. Some S corporations also failed to pay adequate wages to shareholders for their labor for the corporation, which led to underpaying employment taxes. Joint Committee on Taxation (JCT) and Treasury Inspector General for Tax Administration (TIGTA) reports show that inadequate shareholder wage compensation is a significant issue. Using IRS NRP data, GAO calculated **that in the 2003 and 2004 tax years, the net shareholder compensation underreporting equaled roughly \$23.6 billion**, which could result in billions in annual employment tax underpayments. Stakeholder representatives, IRS officials, and TIGTA have indicated that determining adequate shareholder compensation is highly subjective and hinders compliance and enforcement. IRS provides limited guidance on determining adequate compensation. Stakeholder representatives indicated that specific IRS guidance for both new and existing S corporations could help improve compliance. Additionally, IRS examiners often were not taking advantage of certain techniques in examining shareholder compensation. Analyzing a random sample of IRS examinations, GAO found that in cases where IRS examiners did document a form of analysis, they were more likely to make an adjustment than when no evidence of such analysis existed. Currently, IRS does not require specific documentation of their analysis for shareholder compensation by examiners. Legislative options exist to improve compliance with shareholder compensation rules; however, these options also raise notable trade-offs. *Noncompliance with S Corporation Tax Rules, supra* note 2 at 29-32. .

- ii. S corporations must pay employment taxes on wage compensation paid to officers and employees. S corporations may be tempted to pay shareholder-employees an inadequate wage and higher distributions to avoid employment tax liabilities. **A single level of taxation, the ability to pass through business losses to shareholders, and calculating employment taxes on wages rather than net business income are the most significant tax-related reasons that business owners elect treatment as an S corporation. For 2003-2004 887,000 S corporations misreported shareholder compensation. The net misreported amount was \$23,600,000 and the median was \$20,127.** Of the S corporations misreporting S corporation shareholder compensation 93% understated such compensation. **Of the S corporations under stating officer compensation 15% had 1 shareholder; 10%, 2-3 shareholders; and 4%, 4 or more.** The difficulty and subjectivity in determining what constitutes an adequate wage enables some S corporations to pay inadequate wage compensation for the labor provided and compensate their officers through higher amounts of distributions, payments of personal expenses, and/or loans. According to NRP data for tax years 2003 and 2004, about 13 % of S corporations paid inadequate wage compensation, resulting in just over \$23.6 billion in net underpaid wage compensation to shareholders. To illustrate the potential impact on employment tax revenue loss from paying inadequate wages, GAO guesstimated \$3 billion in employment tax revenue losses over tax years 2003 and 2004. The vagueness of federal tax law on determining adequate wage compensation for shareholders means that the facts and circumstances

have to be analyzed in each case. Doing so increases the burden for S corporations to determine adequate compensation and creates opportunities for avoiding employment taxes by paying inadequate compensation.

*Noncompliance with S Corporation Tax Rules, supra* note 2 at 26.

- iii. Several IRS examiners told GAO that arriving at a justifiable conclusion about what constitutes adequate compensation can be difficult, time consuming, and result in a relatively low tax adjustment for the work involved. In determining adequate shareholder compensation, IRS examiners stated that they look at a variety of factors. However, **due to the difficulties in determining adequate shareholder compensation, examiners said that they tend to only pursue the issue in the most egregious cases where shareholders are paid little to no wages and receive large distributions.** A 2002 TIGTA report found that IRS examiners did not always address officer compensation, even when little to no compensation was paid. *Noncompliance with S Corporation Tax Rules, supra* note 2 at 27.
- iv. In analyzing IRS annual examination data for fiscal years 2006 through 2008, GAO found that **IRS only examined 0.5 % or less of the S corporations that filed Form 1120S. IRS examined shareholder compensation usually in well less than a quarter of these examinations over these years.** In GAO's review of randomly selected NRP examination files, it found evidence of some kind of analysis to determine adequacy in 24 of 114 examinations where IRS determined that shareholder compensation needed review. **These analyses included benchmarking tools such as monster.com, salary.com, and Bureau of Labor Statistics (BLS) wage data.** In the other 90 examinations, examiners did not document an analysis, and in some cases merely reconciled an officer's W-2 form to the return. Examiners made adjustments in 10 of the 24 cases where documentation showed that an analysis had been made and in 16 of the other 90 cases. In these 26 examinations with adjustments due to inadequate shareholder compensation, the adjustment amount averaged \$30,000. *Noncompliance with S Corporation Tax Rules, supra* note 2 at 28-29.

#### **D. NRP S Corporation Audits for 2003-2004 Returns**

- i. Joint Committee on Taxation and TIGTA agree that the Service does not have recently trained, revenue resources to audit and challenge under compensation in the sole shareholder and majority controlled by a single shareholder S corporation carrying on a trade or business (other than rental).<sup>13</sup> The Inspector General concluded that determining what is reasonable compensation to pay a business officer is complex and subjective. He earlier testified **that since the Service is forced to address the issue of reasonable officer compensation on a case-by-case basis, many owners of S corporations have apparently**

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<sup>13</sup> TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, THE NATIONAL RESEARCH PROGRAM STUDY OF S CORPORATIONS HAS BEEN EFFECTIVELY IMPLEMENTED, BUT UNNECESSARY INFORMATION WAS REQUESTED FROM TAXPAYERS 5 (2007-30-027 Jan. 30, 2007); *2005 Senate Finance Hearing supra* note 10 at 176 (Written statement of Chief of Staff George Yin) (enforcement of reasonable compensation "rule by government may be difficult because it involves factual determinations on a case-by-case basis.").

*determined that saving employment taxes by minimizing salaries is worth the risk of a Service audit.*<sup>14</sup>

- ii. The extremely low audit rates of S corporations and wage taxes for the last decade or so with the decline accelerating from 1998 to 2004 with a recent recovery of around 50% of that decline, but wholly through **Correspondence Audits tending to be largely ineffective as to high income taxpayers.**<sup>15</sup> **While this audit ratio is projected to increase, it still can cover only a fraction of the S corporations engaging in officer under compensation.**
- iii. Joint Committee on Taxation and TIGTA agree that **IRS does not have recently trained, revenue resources to audit and challenge under compensation in the sole shareholder and majority controlled by a single shareholder S corporation carrying on a trade or business (other than rental).**<sup>16</sup> that the 15,200 audits of S corporations for 2001 (the high water mark for 2001-03 dropping to 9,695 by 2003<sup>17</sup>) were not enough even to pick up the

<sup>14</sup> 2005 Senate Finance Hearing *supra* note 10 at 20 (testimony of Treasury Inspector General for Tax Administration Russell George). Joint Committee Chief of Staff George Yin agreed that [t]here is an enforcement issue. Because under current law the requirement is based on reasonable compensation. So, it is a question of, to what extent is that being well enforced. But that is a very difficult line to enforce. So I would concur with Mr. George that, as our testimony suggested, that statutory changes are needed, not just in the Subchapter S area, but in all of the other areas, the limited liability companies and partnerships as well.

*Id.* at 30.

<sup>15</sup> See TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, WHILE EXAMINATIONS OF HIGH-INCOME TAXPAYERS HAVE INCREASED, THE IMPACT ON COMPLIANCE MAY BE LIMITED 1-2 (2006-30-105 July 25, 2006) (“The IRS conducts examinations of taxpayer returns through two techniques: (1) correspondence examinations are conducted by sending the taxpayer a letter requesting verification of certain items on the tax return and (2) office and field examinations are conducted by examiners who hold face-to-face meetings with taxpayers to verify information.); *Hearing on A Closer Look at the Size and Sources of the Tax Gap Statistics Before the Senate Committee on Finance’s Subcommittee on Taxation and IRS Oversight*, S. Hearing, No. 109-1004, 109th Cong., 2nd Sess. 84-5 Figs. 1 and 2, 159 (2007)(response to written question by Senator Kerry by TIGTA Russell George) (“It is probable that these types of examinations [correspondence audits] are ineffective for certain types of taxpayers, which may include high-income non-filers. At the same time, severe penalties and aggressive enforcement actions may be options to increase the response rate.”) (“SIZE AND SOURCES OF THE TAX GAP”).

<sup>16</sup> TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, THE NATIONAL RESEARCH PROGRAM STUDY OF S CORPORATIONS HAS BEEN EFFECTIVELY IMPLEMENTED, BUT UNNECESSARY INFORMATION WAS REQUESTED FROM TAXPAYERS 5 (2007-30-027 Jan. 30, 2007).

<sup>17</sup> TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2006 10, 40 Figure 39 (2007-30-056 Mar. 27, 2007) (After declining 75% from FYs 1998 to 2004, the numbers of Forms 1120S examined increased 63% in FT 2005 and another 34% in 2006. These increases are partly attributable to examinations of Forms 1120S as part of an ongoing National Research Project studying tax compliance. The study, carried out under the National Research Program (NRP), examined 5,000 randomly selected S corporation returns from tax years 2003 and 2004. Note that the *percentage* of S corporation returns audited decreased even more that the *number* examined and increased less in 2005 and 2006 due to the explosion of the number of S corporations. Examination Rates for S Corporation Returns (FYs 1996 – 2005):

Fiscal Year	Returns Examined	Coverage Rate
1996	19,490	0.92%
1997	23,898	1.04%
1998	25,522	1.04%
1999	21,169	0.81%

entire 36,000 single shareholder-controlled S corporations reporting at least \$100,000 in business profits and paying no formal wages to officers.<sup>18</sup> While S corporation audits increased 2006-2007 the audit coverage remained in the .4 to .5 % range; and the number of S corporation compensation audits ranged from 2,000 to almost 4,000 being raised in 14 % to just over 20 % of the S corporation audits.<sup>19</sup>

- iv. Additionally, the low audit coverage rates of S corporations (lowest of the taxable categories of returns in recent years) had been exacerbated by auditors historically not always addressing officer compensation in audits of S corporations showing distributions to shareholders while reporting little or no officer compensation.<sup>20</sup> More recently, GAO reports that the Subchapter S Corporation NRP audits which did examine adequacy of officer compensation “generally did not document much analysis of the adequacy of the wages paid.”<sup>21</sup> In subsequent fiscal years 2006-2008 when the percentage of S Corporation returns audited ranged from 0.4 to 0.5 % the percentage of such audits examining adequacy of officer compensation ranged

2000	15,200	0.55%
2001	12,437	0.43%
2002	11,646	0.39%
2003	9,695	0.30%
2004	6,400	
2005	10,410	

Sources: Treasury Inspector General for Tax Administration analysis of IRS data. 2005 Senate Finance Hearing, *supra* note 10 at 63.

<sup>18</sup> TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, FILING CHARACTERISTICS AND EXAMINATION RESULTS FOR PARTNERSHIPS AND S CORPORATIONS 3, 11 (2006-30-114 Aug. 28, 2006). No change audits for 2004 had been 29.16%. *Id.* at 11 Fig. 7. Increase for 2005 “can be partly attributed to examinations of Forms 1120S as part of a Nation Research Project. Most of these examinations have been completed.” TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2006 17 (2007-30-056 Mar. 27, 2007); TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2007, 39 Fig. 36. (2008-30-095 Apr. 18, 2008))

<sup>19</sup> Estimated Number of S Corporation Examinations with Shareholder Compensation Issues, Examinations Closed in Fiscal Years 2006 to 2008.

	2006	2007	2008
Number of S corporations filing Form 1120S	3,715,249	3,909,730	4,155,830
Number of S corporations examined	13,970	17,657	16,634
Number of S corporations examined for shareholder compensation	2,004	3,819	2,597
Percentage of all S corporations examined	0.4	0.5	0.4
Percentage of S corporation examinations that covered adequate compensation	14.3	21.6	15.6

*Noncompliance with S Corporation Tax Rules, supra* note 2 at 28.

<sup>20</sup> Treasury Inspector General for Tax Administration, *The Internal Revenue Service Does Not Always Address Subchapter S Corporation Officer Compensation During Examinations* 2 (2002-30-125 Jul. 2002) (“IRS classifiers were unable to effectively identify and classify S Corporation officer compensation non-compliance because the IRS computer systems capture limited tax return data on S Corporations. Also, better methods are needed to measure the results of the IRS’ efforts to address S Corporation officer compensation compliance. Finally, the Taxpayer Education and Communication (TEC) function could improve its taxpayer outreach efforts regarding S Corporation compliance.”).

<sup>21</sup> *Noncompliance with S Corporation Tax Rules, supra* note 2 at 28-29 (in random selection of NRP files only 21% of examinations determining that shareholder compensation needed review contained evidence of same kind of analysis).

from 13.3 to 15.6 %.<sup>22</sup> This in the range of the 13 % of S Corporation returns paying inadequate compensation indicated by the 2003-2004 returns NPR data.<sup>23</sup>

## **E. 2005 Senate Finance Committee Hearing**

### **i. 2000 Statistics**

1. 36,000 single-shareholder S-corporations with greater than \$100,000 in profits passed through total business profits of \$13.2 billion without paying any employment taxes.<sup>24</sup>
2. The average S-corporation in this set made \$366,666 in business profits without paying any compensation to officers who rendered more than minor services
3. 399,000 additional single-shareholder S-corporations with less than \$100,000 in business profits also paid no compensation to their shareholder, which shielded an additional \$9.1 in profits from wage taxes.<sup>25</sup>
4. These 435,000 single-shareholder S-corporations which paid no shareholder compensation despite business profits make up about 21.9% of all the 1,985,171 single-shareholder S-corporation.<sup>26</sup>
5. Another 43,673 single-shareholder S corporations with \$14 billion in aggregate business profits paid between 1 and 9% of business profits as compensation to shareholder officers.
6. Additionally, 89,332 single shareholder S corporations with \$17 billion in business profits paid between 10 and 19% of business profits as compensation to shareholder officers.
7. Finally 92,307 single-shareholder S corporations with \$17.5 billion in business profits paid between 20 and 29% of business profits as compensation to shareholder officers. In short, between 80 and 90% of another \$31 billion in shareholder compensation was not being reported for wage tax purposes.

## **F. Joint Committee on Taxation**

### **i. Tax Gap Options**

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<sup>22</sup> *Id.* at p.28, Table 7.

<sup>23</sup> *Id.* at 25.

<sup>24</sup> *2005 Senate Finance Hearing, supra* note 10 at 19 (statement of Hon. Russell George, Treasury Inspector General for Tax Administration).

<sup>25</sup> *Id.* at 45 "Variations in Salaries Selected by Owners of Single-Shareholder S Corporations (Tax Year 2000)" (prepared statement of statement of Hon. Russell George, Treasury Inspector General for Tax Administration ) Total business profits of single shareholder S corporations paying no compensation to officers for 2000 was \$23.1 billion; total number of such S corporations, 435. The bar graph indicates that this 399,000 S corporations with business profits but paying no officer compensation break down roughly as follows: 280,000 reporting less than \$25,000 accounted for \$2 billion in the aggregate; the 80,000 reporting from \$25,000 to \$49,999, accounted for \$2.8 billion in the aggregate; and the 39,000 reporting from \$50,000 to \$99,999, accounted for \$3.1 billion in business profits in the aggregate. Thus, the 39,000 single shareholder S corporations reporting from \$50,000 to \$99,999 in business profits accounted for 39% of the business profits of this category of single shareholder S corporations with less than \$100,000 in business profits while constituting only 10% of such corporations.

<sup>26</sup> Determined by multiplying the total number of S corporation returns in 2000 (2,860,478), *see* Kelly Bennett, *S Corporation Returns, 2000*, 22 STATISTICS OF INCOME (SOI) BULLETIN 63, 115 tbl.5 (2003), *available at* <http://www.irs.gov/pub/irs-soi/00scorp.pdf>, by the number of single-shareholder S corporations (69.4%).

1. Proposal to treat returns on labor (but not on capital) for both materially participating partners<sup>27</sup> and active S corporation shareholders as wages (or self-employment income) as increasing revenue (apparently only FICA or on-budget portion) for 2005 (from then assumed date of enactment) through 2010 in the aggregate of \$23 billion (for the period 2005-14, \$57.4 billion).
2. "Over the period 2006-2015, this option is estimated to increase on-budget revenues by \$36.3 billion, increase off-budget revenues by \$28.2 billion, and increase outlays by \$0.5 billion, for a net increase in revenues of \$64 billion overall."<sup>28</sup>

## G. TIGTA

### i. 2002 Pool

1. In 2002 the Treasury Inspector General for Tax Administration selected 84 S corporations out of a pool of 385 S corporations that had less than \$10,000 of officer compensation and S corporation ordinary income greater than \$50,000 for 1998 and for which IRS examination had been closed.<sup>29</sup>
  - a. In this sample of 84 S corporations only 58 reported officer distributions such as cash or property or loans.<sup>30</sup>
  - b. In this subset of 58 cases IRS examiners did not address officer compensation in 13 (22% of the cases).<sup>31</sup>
  - c. In this sample of 84 S corporation tax returns average officer wages were \$5,300 and average distribution of profits was \$349,323.<sup>32</sup>

### ii. 2005 TIGTA

1. 78.9% of all S-corporations were either wholly owned by a single shareholder (69.4%) or had a single shareholder control more than 50% of the stock (9.5%).
  - a. This is significant because where one person is solely controlling and operating an S-corporation, the determination of salary is unilateral, highly subjective and influenced by the knowledge that a higher salary will result in higher employment taxes and therefore lower profits.<sup>33</sup>
2. Number of Shareholders

<sup>27</sup> This was to cover limited partners and members of limited liability companies who materially participated in the entity's business.

<sup>28</sup> 2005 Senate Finance Hearing, *supra* note 10, at 174, 177 (testimony of George K. Yin, Chief of Staff, Joint Committee on Taxation). The increase in outlays probably would arise from S corporation shareholders increasing accrual of social security benefits. Economist witnesses at the Hearings testified that such increased benefits should be taken into account. *Id.* at 25 (testimony of Dr. Douglas Holtz-Eakin, Director Congressional Budget Office).

<sup>29</sup> TREAS. INSPECTOR GENERAL FOR TAX ADMIN., FINAL AUDIT REPORT: THE IRS DOES NOT ALWAYS ADDRESS SUBCHAPTER S CORPORATION OFFICER COMPENSATION DURING EXAMINATIONS (2002), available at <http://www.treasury.gov/tigta/auditreports/2002reports/200230125fr.html>

<sup>30</sup> *Id.* at 1.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* at 3

<sup>33</sup> 2005 Senate Finance Hearing, *supra* note 10 at 50 (prepared statement of Hon. Russell George, Treasury Inspector General for Tax Administration).

- a. 55.9% have one shareholder
  - b. 29.8% have two shareholders
    - i. TIGTA counts spousal shareholders as a single shareholder, a position supported by the Code.
3. Underfunding
- a. TIGTA estimated in 2005 that absent changes in the law for 2006-2010, the Social Security and Medicare employment tax gaps resulting from under-compensation of Subchapter S shareholders would amount over such period to \$30.8 and \$30.2 billion, respectively.<sup>34</sup>
  - b. In 2000 alone single-shareholder S-corporations paid \$5.7 billion less than if they had been treated as sole-proprietors.<sup>35</sup>
    - i. The total tax gap from employment underreporting is about \$54 billion.<sup>36</sup>
  - c. In 2003 TIGTA later estimated that sole shareholder S corporations avoided “nearly \$8.4 billion in employment taxes in TY 2003, or \$4,404 on the average”<sup>37</sup>
4. Salary Paid
- a. Owners of single-shareholder S corporations paid themselves salaries subject to employment taxes that equaled only 47.1% of their profits in TY 1994, which fell to just 41.5% by TY 2001.<sup>38</sup>
  - b. For 2003 the percentage had fallen further to 40.25%.<sup>39</sup>

### III. Wage Tax Authorities

- A. Where a shareholder is also an employee of the S corporation, both the S corporation and the employee-shareholder have an incentive to characterize a payment to the employee-shareholder as a dividend (or some other non-wage) distribution rather than as compensation for such services because only payments for compensation are subject to Federal employment taxes if the form of the distribution is respected.<sup>40</sup>

<sup>34</sup> The Service’s updated estimate of the gross tax gap for 2001 included a \$39 billion tax gap of self-employment taxes and \$15 billion of FICA and unemployment taxes. Internal Revenue Service, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006), available at <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>.

<sup>35</sup> 2005 Senate Finance Hearing, *supra* note 10 at 20 (statement of Hon. Russell George, Treasury Inspector General for Tax Administration).

<sup>36</sup> GOVERNMENTAL ACCOUNTABILITY OFFICE, TAX COMPLIANCE: OPPORTUNITIES EXIST TO REDUCE THE TAX GAP USING A VARIETY OF APPROACHES 4 Table 1 (GAO-06-1000T Jul. 26, 2006). In comparison the individual Tax Gap for 2001 for was estimated to be \$80.4 billion before the National Research program and \$78 billion after. *Hearing on A Closer Look at the Size and Sources of the Tax Gap Statistics Before the Senate Committee on Finance’s Subcommittee on Taxation and IRS Oversight*, S. Hearing, No. 109-1004, 109th Cong., 2nd Sess. 84-5 Figs. 1 and 2 (2007)(Written Statement of TIGTA Russell George)(“SIZE AND SOURCES OF THE TAX GAP”). Most of these figures appear to have consisted of self-employment tax (an area in which there is much greater non-compliance) and the S corporation amounts in general were carried over from the 1984 TCM and did not reflect the 2005 NRP of S corporations. *Id.* at 87

<sup>37</sup> EXAMINATION RESULTS FOR PARTNERSHIPS AND S CORPORATIONS, *supra* note 9 at 6.

<sup>38</sup> 2005 Senate Finance Hearing, *supra* note 3, at 20 (statement of Hon. Russell George, Treasury Inspector General for Tax Administration).

<sup>39</sup> See Luttrell, S Corporation, 2003, *supra* note 1, at 165.

<sup>40</sup> E.g., *Brewer Quality Homes, Inc v. Commissioner*, T.C. Memo 2003-200, *aff’d per curiam*, 122 Fed. Appx. 88; 2004 U.S. App. LEXIS 25273 (5th Cir. 2004). *Accord, Charlotte’s Office Boutique, Inc. v. Commissioner*, 121 T.C.

## B. Not an Employee

- i. Both IRS<sup>41</sup> and the Social Security Administration<sup>42</sup> can *recharacterize* actual distributions (e.g., cast *in the form* of dividends, loans, royalties, etc.) by an S corporation to a shareholder (typically an officer) as wages, if *in substance* they are *payments for services* to the S corporation.

## C. Independent Contractor

- i. After the above IRS substance-over-form victories, some practitioners repeatedly attempted unsuccessfully to evade the wages taxes for themselves and clients by claiming the safe harbor of Revenue Act of 1978 Section 530 for treatment by the corporation of the shareholder as an independent contractor for whom no withholding of wage taxes was required,<sup>43</sup> while most of the S

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89, 105 (2003), *aff'd*, 425 F.3d 1203 (9th Cir. 2005); *Joseph Radtke, S.C. v. United States*, 712 F. Supp. 143, (E.D. Wis. 1989), *aff'd*, 895 F.2d 1196 (7th Cir. 1990) (“substance, not the form” controls as to whether S corporation dividends to shareholder who performs substantial services without any direct compensation constitute “wages”); Rev. Rul. 74-44, 1974-1 C.B. 287; *Construction & Design Co., v. United States Citizenship & Immigration Services*, 563 F.3d 593, 595-96 (7th Cir. 2009) (Posner, J) (“The distinction between accounting profits, losses, assets, and liabilities, on the one hand and cash flow on the other is especially important when one is dealing with either a firm undergoing reorganization in bankruptcy or a small privately held firm; in the latter case, in order to avoid double taxation (corporate income tax plus personal income tax on dividends), the company might try to make its profits disappear into officers’ salaries. *See Menard, Inc. v. Commissioner*, 560 F.3d 620, (7th Cir. Mar. 10, 2009). The owners of a Subchapter S corporation, however, have the opposite incentive--to *alchemize salary into earnings*. A corporation has to pay employment taxes, such as state unemployment insurance tax and social security tax, on the salaries it pays. A Subchapter S corporation can avoid paying them by recharacterizing salary as a distribution of corporate income. To limit the ability of shareholder-employees to minimize their salaries and thus the company’s employment taxes, the government requires that they be paid ‘reasonable salaries.’”)(emphasis added); Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* 98, 102 (JCS-02-05 Jan. 27, 2005).

<sup>41</sup> *Spicer Accounting, Inc. v. United States*, 918 F.2d 90, 92 (9th Cir. 1990)(in determining whether S corporation dividends are wages for employment taxes, courts “must look at the substance of the transaction, not the form”); *Joseph Radtke, S.C. v. United States*, 712 F. Supp. 143, (E.D. Wis. 1989), *aff'd*, 895 F.2d 1196 (7th Cir. 1990) (“substance, not the form” controls as to whether S corporation dividends to shareholder who performs substantial services without any direct compensation constitute “wages”).

<sup>42</sup> *Ludeking v. Finch*, 421 F.2d 499, 502-03 (8th Cir. 1970)(The purpose of the benefit provisions of the Social Security Act require on the basis of fairness and equality of treatment that some of distributed Subchapter S dividends be considered under substance over form to be wages). *Accord, Pointer v. Shalala*, 841 F. Supp. 201, 204 (N.D. Tex. 1993).

<sup>43</sup> (Never mind that the shareholder-independent contractor never reported the distributions as self-employment income.) On the *same day* in 2002 the Tax Court handed down 6 almost identical cases involving James M. Grey, CPA, sole shareholder in an S corporation with business profits who was paid no formal compensation claiming that he was an independent contractor, and five of his clients. All lost in the Tax Court and on appeal on the grounds there was no reasonable basis under Section 530 to not treat the sole shareholder officer who is the corporation’s central worker as an employee. *Joseph M. Grey Public Accountant, P.C., v. Commissioner*, 119 T.C. 121 (2002), *aff'd without published opinion*, 93 Fed. Appx. 473 (3rd Cir.), *cert. denied sub nom. Nu-Look Design, Inc. v. Commissioner*, 543 U.S. 821 (2004). Another series of zero compensation corporate officers this time linked by the same tax adviser attorney, Robert E. Kovacevich, span 1990 through 2006 and display shifting tactics, or at least fora, as the taxpayers lost. The most well-known is *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990)(Ninth Circuit rejected alternative arguments that (a) payments made to stockholders in a subchapter S corporation were not wages but dividends and (b) the shareholder-officer was an independent contractor, denying Section 530 relief because there was no reasonable basis for not treating the sole shareholder/full time worker as an employee); *Van Camp & Bennion, P.S. v. United States*, 1996 U.S. Dist. LEXIS 10889 (E.D. Wash. 1996)(one attorney performing substantial services, held statutory employee, other semi-retired performing minimal services held independent contractor), *remanded without opinion* 238 F.3d 433 (9th Cir. 2000)(remanded to determine



corporations' profits were structured as loans, dividends or royalties to their officer shareholders providing more than minor services.

**D. Some but Still Unreasonable Compensation**

- i. With rare exceptions,<sup>44</sup> in the above cases the shareholder performing services did not include any amount as wages. **Commentators suggest that absent abusive zero compensation and all withdrawals cast as dividends, “the IRS may have difficulty asserting that dividend distributions made by an S corporation to shareholder-employees who are otherwise paid reasonable salaries should be characterized as additional wages subject to Social Security taxes.”<sup>45</sup> Anecdotally many concluded that as long as some wages were paid, S shareholder-employees had little to worry about.**
- ii. Very recently two federal district court opinions indicate that relatively substantial officer compensation may not shield distributions by an S corporation from re characterization as compensation for wage tax purposes.
- iii. **David E. Watson P.C., a sole shareholder S corporation, was a 25% partner in an accounting firm (with four equal partners), LWBJ.<sup>46</sup> The S corporation paid its sole shareholder, Watson, a salary of \$24,000 in both 2002 and 2003 and paid federal employment taxes on that amount. In 2002 in addition to such salary the S corporation distributed to Watson \$203,651 of which it recorded \$118,159 as dividends and the balance apparently as interest free loans. In 2003 in addition to his \$24,000 salary, Watson received from the S corporation \$221,577 as dividend payments. In each year reported compensation was approximately 10% of reported compensation plus distributions.<sup>47</sup> In 2007 IRS determined that \$130,730.05 of the 2002 dividend**

amount of refund), *remand affirmed* 251 F.3rd 862 (9th Cir. 2001); *Seeds, Inc v. United States*, 1998 U.S. Dist. LEXIS 15378 (E.D. Wash. 1998)(11% shareholder/treasurer performed only minor services and not under title of treasurer, held independent contractor). Then in 2000 Kovacevich shifted to the Claims Court in *Western Management, Inc. v. United States*, 45 Fed. Cl. 543 (2000)(no reasonable basis for the corporation not treating the attorney-shareholder as an employee). In 2003 the attorney forum shifted to the Tax Court in a case with a more sophisticated structuring of payment of a minimum salary plus distributions cast as rents and royalties-- still to no avail in *Charlotte's Office Boutique, Inc. v. Commissioner*, 121 T.C. 89 (2003), *supplemental opinion*, T.C. Memo 2004-43, *aff'd* 425 F.3<sup>rd</sup> 1203 (9th Cir. 2005)(taxpayer used intangible property in her sole proprietorship to earn self-employment income subject to self-employment tax, she can't "avoid the payment of Federal employment taxes simply by declaring that she will be paying royalties to herself through a controlled corporation for its use of that property.").

<sup>44</sup> *Charlotte's Office Boutique, supra*.

<sup>45</sup> C Wells Hall, III, & Jordan P. Rose, *Considerations in Choice of Entity Revisited*, N.Y.U. 62ND INST. ON FED. TAX. §15.06[3][f][iv], p. 15-05 (2004). *Options to Improve Tax Compliance, supra* note 1 at 111 ("enforcement of this rule by the government may be difficult because it involves factual determinations on a case-by-case basis."); Joint Committee on Taxation, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity* 68 (JCX-48-08 June 4, 2008)("requiring taxpayer audits and potentially involving costly, resource-consuming litigation"); *Noncompliance with S Corporation Tax Rules, supra* note 2 at 27.

<sup>46</sup> *David E. Watson P.C. v. United States* 757 F. Supp. 2d 877 (S.D. Iowa May 27, 2010).

<sup>47</sup>

	1	2	3	4	5	6
Tax year	Reported compensation	Reported dividends	Compensation as percentage of 1+2	Distributions in excess of compensation	Compensation as percentage of 1+4	Compensation recharacterized by IRS as wages
2002	\$24,000	\$118,159	16.88%	\$203,651	10.54%	\$130,730

payments to Watson should be recharacterized as wages subject to employment taxes; and \$175,470.00 of the 2003 dividend payments, as wages subject to employment taxes. **Upon audit David E. Watson P.C. recharacterized \$67,044.00 of the dividend distributions as wages for each of 2002 and 2003,**<sup>48</sup> paid \$4,064 of the assessments of \$48,519.30 for such years for wage taxes, penalties and interest. David E. Watson P.C. then sued in the district court for a refund of such payment.

At trial in *David E. Watson P.C. v. United States* the IRS expert relying on outside studies concluded that (1) the S corporation and the accounting firm were considerably more profitable than peers (twice as profitable in the latter case), (2) Watson's salary was lower than reported median salary for new accounting graduates, and (3) AICPA Management Accounting Practice "survey indicated that an average 'owner' (defined as both an investor in and an employee of a firm) in a firm the size of LWBJ would receive approximate \$176,000 annually, reflecting both compensation and return on investment. A director (defined as solely an employee with no investment interest) would realize approximately \$70,000 compensation annually. \*\*\* [The IRS expert] evaluated billing rates for owners and directors and found that owners billed at a rate approximately 33% higher than did a director. Accordingly, [he] increased the director's estimated compensation by 33% to obtain an estimated comparable salary for someone in Watson's position of approximately \$93,000. [He] then reduced this amount to \$91,044 to account for certain untaxable fringe benefits."<sup>49</sup>

The district court in *Watson* rejected the taxpayer's main contention that the S corporation's intent *controlled* whether a distribution was compensation or a dividend. The *Watson* court relied on well-known substance over form decisions<sup>50</sup> and an unreported case discussed immediately below.

**A reasonable person in Watson's role within LWBJ would unquestionably be expected to earn far more than a \$24,000 salary for his services. As such, the \$24,000 salary Watson opted to pay himself as DEWPC's sole shareholder, officer, and employee, is incongruent with the financial position of LWBJ and in light of Watson's experience and contributions to LWBJ, and when compared to the approximately \$200,000 in distributions DEWPC**

2003	\$24,000	\$221,577	09.77%	\$221,577	09.77%	\$175,470
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"Some" of the difference in 2002 between reported dividends and distribution was treated by taxpayer as interest free loans.

<sup>48</sup> Apparently the taxpayer was attempting to treat belatedly as "reasonable" compensation an amount approximating the taxable wage base which was \$84,900 and \$89,000 for 2002 and 2003, respectively. See [www1.umn.edu/ohr/payroll/tax/wagelimits/index.html](http://www1.umn.edu/ohr/payroll/tax/wagelimits/index.html).

<sup>49</sup> *Watson*, 757 F. Supp. 2<sup>nd</sup> at 883-84 (emphasis added).

<sup>50</sup> *Rev. Rul. 74-44; Joseph Radtke, S.C. v. United States; and Spicer Accounting, Inc. v. United States. Watson*, 757 F. Supp. 2<sup>nd</sup> at 887, 889 ("the characterization of funds disbursed by an S corporation to its employees or shareholders turns on an analysis of whether the 'payments at issue were made . . . as remuneration for services performed.' *Radtke*, 895 F.2d at 1197. This approach conforms with well settled jurisprudence holding that tax consequences are governed by the economic realities of a transaction, not by the form of the transaction or labels given it by the parties.").

received in each of 2002 and 2003. Moreover, the \$24,000 salary is low when compared to salaries that could reasonably be expected to be earned by persons with experience similar to that of Watson, and holding a position such as Watson held in a firm comparable to LWBJ. Indeed, upon evaluation of all of the facts and circumstances in this case, the Court is convinced that DEWPC structured Watson's salary and dividend payments in an effort to avoid federal employment taxes, with full knowledge that dividends paid to Watson were actually "remuneration for services performed."\*\*\*

Accordingly, the Court adopts Ostrovsky's calculations and finds that, for each of the years 2002 and 2003, the reasonable amount of Watson's "remuneration for services performed" was \$91,044. This amount is \$67,044 more than the \$24,000 annual salary paid by DEWPC to Watson, and DEWPC, accordingly, is obligated to pay the appropriate FICA taxes, interest, and penalties on the recharacterized amounts<sup>51</sup>

Note that \$91,044 is slightly more than the taxable wage base for 2002 and 2003 and slightly less than 50% of the total distributions by the S corporation. Thus, Watson factually supports a conventional rule of thumb as to "reasonable compensation" in single-shareholder S corporations of paying to the officer-shareholder wages equal to either the covered wages under FICA (\$106,800 for 2011<sup>52</sup>) or ½ of business profits.<sup>53</sup> Moreover, judging from the media, including business magazines published by AICPA,<sup>54</sup> U.S. Chamber of Commerce,<sup>55</sup> and Business Week,<sup>56</sup> most reputable tax

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<sup>51</sup> *Watson*, 757 F. Supp. 2<sup>nd</sup> at 890, 891 (emphasis added).

<sup>52</sup> <http://www1.umn.edu/ohr/payroll/tax/wagelimits/index.html>

<sup>53</sup> Cyndia Zwahlen, *Small-Business Report; Small moves could trigger IRS audits*, L.A. TIMES, Mar. 7, 2007, at C-6 ("Some suggest the corporation set aside 50% of profit for salaries, others suggest claiming at least the full amount that is subject to Social Security and Medicare tax ... .")("Failure to take a reasonable compensation from your S corporation is a flag to the IRS that you may be underreporting your true income and thus avoiding income and payroll taxes."); Ann Meyer, *Tax rules complicate salary situation*, CHICAGO TRIBUNE, Dec. 2, 2002, at B-3 ("a good rule of thumb is to pay yourself the maximum that is subject to Social Security tax ... and the IRS should be satisfied, experts say. 'If you pay yourself much less than that, you risk the IRS challenging you that your compensation is unreasonably low.'").

<sup>54</sup> Roger Russell, *IRS S corporation audit plan draws mixed reviews*, 19 ACCOUNTING TODAY 3 (Sept. 5, 2005)(Tax Liaison Committee chairman of the American Association of Attorney-CPAs believed that there is a fair amount of abuse. "People are taking salaries that are too low, sometimes as little as zero, to beat the 15 percent FICA tax. Or there are those who pay themselves \$10,000, but take out \$90,000 in distributions.")(Director of Government Affairs National Small Business Association agreed that "some things are indefensible - for example, taking a \$5,000 salary and \$95,000 in distributions [but] our membership is always concerned when the IRS decides to ramp up audits of small businesses.").

<sup>55</sup> Gloria Gibbs Marullol, *The Question Of Payment For S Corporations' Owners*, NATION'S BUSINESS 28 (Sept. 1998)(quoting IRS agent, "So when we look at the line for officers' compensation on an S-corporation return and see a shareholder who works 100 percent of his time in the corporation, takes a salary of 5,000, and has distributions of \$60,000, we're going to get curious.")(CPA "advises the owner-employees of profitable S corporations to use the Social Security FICA limit as a rock-bottom guide for salary."); Randy Myers, *Setting the Size of Your Paycheck*, NATION'S BUSINESS 30 (July 1998)(quoting CPA, "If you want to get yourself a quick audit, show a profitable S corporation making distributions without paying any salary to the owner.").

<sup>56</sup> Lynn Brenner, *Tax Facts*, BUSINESS WEEK SB-40 (Apr. 2, 2001)("DON'T ...claim a tiny salary from your profitable S corporation to minimize Social Security and Medicare taxes. It's a red flag to the IRS."); Roy Furchgott,

professionals would agree that a zero compensation S corporation officer-shareholder rendering more than minor services to a profitable S corporation is scoffing<sup>57</sup> at the “reasonable compensation” requirement of the tax law.<sup>58</sup>

- iv. *Watson* also cited an unreported district court case-- *JD & Associates, Ltd. v. United States*.<sup>59</sup> There an S corporation carrying on a professional business paid compensation to its sole (professional) shareholder ranging from 25 to 39% of its ordinary income over a 3 year period.<sup>60</sup> IRS determined the taxpayer’s reasonable compensation on the basis of expert opinions of an Accredited Valuation Analyst based on a national survey of financial ratios<sup>61</sup> and assessed additional taxes based on this determination. The taxpayer paid about 10% of the assessed amount and sued for a refund of this payment. The government resisted the taxpayer’s refund claim and counter claimed for the balance of the assessment. The district court applied traditional reasonable compensation multi factors<sup>62</sup> finding the taxpayer’s claim without merit and the government’s counter claim valid.
- v. If a business was essentially providing services, and perhaps selling a few goods incidental to providing the services, capital has not been deemed a material

*Not Quite Ready to Stop Working?*, BUSINESS WEEK 131 (July 17, 2000)(quoting a certified financial planner)(“Some people take 100% as profit and zero in salary. That’s very aggressive, and the IRS can come in and hit you with taxes”).

<sup>57</sup> 2005 Senate Finance Hearings, *supra* note 10 at 30.

<sup>58</sup> Ilana DeBare, *Mind Your Business; With unconventional service, influence the influencers*, SAN FRANCISCO CHRONICLE, Sept. 20, 2006, at C-1 (quoting CPA)(“If you are drawing a zero or low salary, watch out, because you’ll have the auditors coming after you.”); Fritz, *supra* note 72 at 608 (facts are overwhelmingly in IRS’s favor when a controlling shareholder acts as a company’s sole service provider and draws no salary); Diane Hess, *IRS effort could tax small firms; S corporations will be randomly audited; extra work for busy owners*, CRAIN’S NEW YORK BUSINESS 25 (Sept. 19, 2005)(many accountants predict IRS will be watching for S corporation owners who dodge self-employment taxes by paying themselves little or no salary) (quoting tax lawyer, “if someone is an S corp owner, he will want to make sure that he is paying himself a salary”).

<sup>59</sup> (Case No. 3:04-cv-59 D. N.D. May 19, 2006), *electronically available*, [www.bvresources.com/BVWireCentral/Material/BVWire52-3/JDAssocvUS.pdf](http://www.bvresources.com/BVWireCentral/Material/BVWire52-3/JDAssocvUS.pdf).

<sup>60</sup>

year	1 Reported compensation	2 Ordinary income	3 Percentage 1 of 2	4 Dividend paid next year as to advances in prior year	5 IRS determination of reasonable compensation
1997	\$19,000	\$76,221	24.93%	\$47,000	\$61,817
1998	\$30,000	\$83,667	35.86%	\$50,000	\$63,673
1999	\$30,000	\$77,320	38.80%	\$50,000	\$77,320

<sup>61</sup> The same IRS expert as in *Watson* applied the same outside surveys.

<sup>62</sup> (1)Employee qualifications; (2) the nature, extent, and scope of the employee’s work; (3) the size and complexity of the business; (4) prevailing general economic conditions; (5) the employee’s compensation as a percentage of gross and net income; (6) the employee-shareholder’s compensation compared with distributions to shareholders; (8) prevailing rates of compensation for comparable positions in comparable concerns; and (9) comparison of compensation paid to a particular shareholder-employee in previous years where the corporation where the corporation has a limited number of officers. *Charles Schneider & Co. v. Commissioner*, 500 F.2d 148, 182 (8<sup>th</sup> Cir. 1974).

income-producing factor in the business. See *United States v. Van Dyke*, 696 F.2d 957 (Fed. Cir. 1982).

For purposes of the limitation of tax rate on earned income §1.1348-3(a)(3)(ii) provided that generally “capital is not a material income-producing factor where gross income of the business consists principally of fees, commissions, or other compensation for personal services performed by an individual. Thus, the practice of his profession by a doctor, dentist, lawyer, architect or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which he conducts his practice since his capital investment is regarded as only incidental to his professional practice from which he or she operated.”

Similarly §736(b)(2) permits payments for “unstated goodwill” to a retiring general partner to be treated as a guaranteed payment or distributive share if capital is not a material income-producing factor. “For purposes of this provision, **capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice.**” H.R. Report No. 103-111; 103 Cong. 1<sup>st</sup> Sess. 782-83 (1993), *reprinted in* 1993-3 C.B. 358-59

The same notion probably underlies temporary PAL regulation §1.469-5T(d):

d) *Personal service activity*. An activity constitutes a **personal service activity** for purposes of paragraph (a)(6) of this section if such activity involves the performance of personal services in-

- (A) **The fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting;** or
- (B) **Any other trade or business in which capital is not a material income-producing factor.** (emphasis added).

In sharp contrast to this approach as to partnerships, etc., where deductibility of reasonable compensation paid by a C corporation has been the issue, payment of a the portion of a corporation’s profits attributable, for example, to the efforts of paralegals and other legal assistants (less their pay and allocable overhead) should not constitute reasonable compensation to the professional shareholder, *Pediatric Surgical Associates P.C. v. Commissioner*, T.C. Memo. 2001-81; nor should payment of profits attributable to professional goodwill, provided that the professional had signed a covenant not to compete, *cf. Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189, 207 (1998); *Schilbach v.*

*Commissioner*, T.C. Memo 1991-556 (some of the goodwill of the medical practice was inherent in the operating entity where physician signed a non-compete covenant and more importantly was leaving the state); *see generally* Tom Daley, *Edwards's S Corporation, Medicare Tax, and Fair Share*, 104 TAX NOTES 1577 (Sept. 27, 2004); Darian M. Ibrahim, *The Unique Benefits of Treating Personal Goodwill as Property in Corporate Acquisitions*, 30 DEL. J. CORP. L. 1 (2005).

- vi. The Joint Committee Staff ably sets out the issues, particularly as to administrability, in separating returns on labor and capital in a service business (opting for the traditional all labor in a services business). Joint Committee on Taxation, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity* 60-72 (JCX-48-08 Jun. 4, 2008).

#### E. Multi-Entity splits

- i. ***Robucci v. Commissioner***<sup>63</sup> Robucci, a psychiatrist, sought advice from Carson an attorney-C.P.A., specializing in choice of tax planning for small businesses,<sup>64</sup> as to minimizing the tax liability arising from his practice. Carson restructured Robucci's practice from a sole proprietorship to a limited liability company (Robucci LLC) with two members: Robucci, owning 95%, and a wholly-owned "manager" corporation (Robucci P.C.), owning 5%. Carson also organized a second corporation (Westsphere) to perform non-patient care management services associated with Robucci's practice. Robucci's 95% in LLC was divided between a 10% general partner interest and an 85% limited partner interest attributable to intangibles associated with the practice. Robucci paid self-employment tax only on distributions associated with his 10% general partner interest, whereas, as a sole proprietor, he was required to pay self-employment tax on the entire net income from his psychiatric practice.

The Tax Court agreed with IRS that Robucci P.C. and Westsphere accomplished no significant business purpose and were, in substance, hollow corporate shells formed primarily for tax avoidance and, therefore, were disregarded for Federal tax purposes. Therefore, Robucci LLC was a single member LLC and not having elected taxation as a corporation was a disregarded entity, resulting in Robucci being taxed as a sole proprietor subject to self-employment tax on all of the income of Robucci LLC. The Tax Court also held Robucci liable to the 20% negligence penalty of §6662 accuracy-related penalty.

**During his first meeting with Carson, Robucci stated that he wanted to minimize the amount of taxes he was paying. After discussing various options to achieve that goal, Carson recommended, and persuaded. Robucci to adopt, an organizational structure, involving an LLC and two corporations. That initial discussion also covered the possibility of structuring Robucci's practice in such a way as to reduce the amount of self-employment tax that he was paying while also minimizing any other tax liabilities that he might incur. Robucci did not seek a second opinion from any other C.P.A.s or**

<sup>63</sup> T.C. Memo. 2011-19, *on appeal to 10<sup>th</sup> Circuit*.

<sup>64</sup> The CPA firm had a client list of some 3,500 clients, mostly small businesses. Choice-of entity planning for those clients constituted a significant portion of the firm's practice.

attorneys assessing the merits of Carson's recommendations, **nor did Carson provide him with a written explanation of the need to form three separate entities. He did explain orally to Robucci that the LLC would conduct the practice, that (for reasons not made clear to Robucci) it needed to have two members (Robucci and what became Robucci P.C.), and that Westsphere would be considered a business management corporation, uninvolved in patient care.**

Robucci was the sole shareholder of both corporations. Robucci's 95% direct LLC ownership interest was reflected on Robucci LLC's partnership returns as split between an 85% interest as a limited partner and a 10% interest as a general partner. **Carson determined the 85% and 10% split in Robucci's LLC ownership interests on his determination of an 85% limited partner ownership interest as the value of Robucci's goodwill and what would be a reasonable rate of return on that goodwill at the time he formed Robucci LLC. Carson never discussed with Robucci the basis for the 85/10% allocation between his limited and general partner interests in Robucci LLC (although Robucci did understand that his 10% general partnership interest represented his interest as a provider of medical services and his 85% limited partnership interest represented his interest attributable to his capital contribution of intangibles), nor did Carson prepare a written valuation in support of his attribution of an 85% limited partner interest to transferred intangibles. Moreover, Robucci did not make any written assignment of the tangible or intangible assets of his practice to Robucci LLC.**

Carson also drafted a document entitled "Operating Agreement" whereby Robucci P.C., with a 5% LLC interest, was designated as manager of Robucci LLC. The Tax Court was uncertain whether Robucci ever executed that agreement on behalf of either of the parties, Robucci P.C. and Robucci LLC. Robucci had a limited understanding of the need for the entities formed and the agreements and other documents drafted by Carson. He relied on Carson's representations that the actions taken would legitimately result in the tax minimization that he sought.

**Robucci did not have an employment agreement with any of the 3 entities and neither of the corporations paid him or anyone else salaries. Robucci did not keep records of any time he might have worked for Westsphere, the management corporation. He was aware that Westsphere charged management fees to Robucci LLC, but he did not know the nature of those charges, other than that they probably related to his time spent performing functions related to his medical practice that did not involve actual patient care.**

**Both before and after the formation of Robucci LLC, Ms. Williams was the billing assistant for Robucci's practice. During the years in issue, although she received instructions from Robucci in letters with a letterhead that referred to "Tony L. Robucci, M.D., A Professional L.L.C.", she still considered herself to be in the employ of Dr. Robucci.**

Beginning with their dates of organization and throughout the years in issue, Robucci LLC and the corporations used the same business address, although there was no written lease agreement between Robucci LLC and either of the corporations. The corporations did not (1) have separate Web sites or telephone listings, (2) pay rent to Dr. Robucci or Robucci LLC, (3) have customers other than Robucci LLC or contracts with any other third parties, or (4) advertise. Westsphere did not have separate dedicated space in Dr. Robucci's office.

The Tax Court reasoned that a "corporation will be recognized as a separate taxable entity if (1) the purpose for its formation is the equivalent of business activity or (2) the incorporation is followed by the carrying on of a business by the corporation. *Moline Props., Inc. v. Commissioner*, 319 U.S. 436, 438-439 (1943).

The Tax Court agreed with IRS that (1) the corporations "were created solely for the purpose of reducing Robucci's tax liability" and, more specifically, to help him "avoid income and self-employment taxes"; (2) Robucci "did not offer any credible explanation of the business purpose for forming the corporations"; and (3) he "did not demonstrate that either corporation engaged in any business activity after it was formed."

While Carson, as sketched above, did not prove written reasons for the above structure, he did hand write a note while his firm was preparing the Robucci P.C. and Westsphere returns for one of the years in issue, in which he states: "*We need P.C. to be a partner in LLC only Westsphere is the mgmt. corp. P.C. does nada [nothing].*"

Our disregard of Robucci P.C. for Federal tax purposes leaves Robucci LLC as a single-member LLC; and because of its failure to make a protective election under section 301.7701-3(a), *Proced. & Admin. Regs.*, to be classified as an association, i.e., as a corporation, see sec. 301.7701-2(b)(2), *Proced. & Admin. Regs.*, it too is disregarded for Federal tax purposes under section 301.7701-3(b)(1)(ii), *Proced. & Admin. Regs.* The result is that Dr. Robucci is treated as a sole proprietor for Federal tax purposes, which was his status before the formation of Robucci LLC and the corporations. It follows, and we hold, that the net income arising from his psychiatric practice during the years in issue, including any amounts paid to Robucci P.C. and Westsphere, was self-employment income of Dr. Robucci subject to self-employment tax under section 1401.

As to the 20% accuracy-rated penalty because there was a "substantial understatement of income tax," the Tax Court did not have to reach whether Robucci was negligent. But its discussion of whether §6664(c)(1) reveals that the court thought that he was. That Section provides that the negligence penalty will not be imposed with respect to any portion of an underpayment if a taxpayer shows that there was reasonable cause for, and that the taxpayer acted in good faith with respect to, that portion. Reasonable cause has been found when a taxpayer selects a competent tax adviser, supplies the adviser with all relevant information and, in a manner consistent with ordinary business care



and prudence, relies on the adviser's professional judgment as to the taxpayer's tax obligations.

**Reliance on a professional tax adviser will not be considered reasonable, however, if the adviser is a promoter of the transaction or suffers from a conflict of interest that the taxpayer knew of or should have known about.** IRS argued that the taxpayer should have requested a second opinion after getting advice that was clearly too good to be true". Respondent views Mr. Carson as "the promoter of the arrangement, who earned substantial fees for incorporating the various sham entities and preparing the tax returns at issue". Petitioners deny that Mr. Carson was a promoter and argues that, in the light of Mr. Carson's status as an independent, experienced C.P.A., Dr. Robucci was under no obligation to obtain a second opinion before he could reasonably rely on Mr. Carson's advice. Even if we were to agree with petitioner that Mr. Carson was not a promoter, we agree with respondent that **the tax result afforded by implementing Mr. Carson's suggestions, i.e., the dramatic reduction in Dr. Robucci's self-employment taxes, was "too good to be true."** See, e.g., *Neonatology Associate, P.A. v. Commissioner*, 299 F.3d at 234 ("When \* \* \* a taxpayer is presented with what would appear to be a fabulous opportunity to avoid tax obligations, he should recognize that he proceeds at his own peril."); *McCrary v. Commissioner*, 92 T.C. 827, 850 (1989) (stating that no reasonable person should have trusted the tax scheme in question to work).

**It is not that Mr. Carson's goal of directing some of Dr. Robucci's income to a third-party corporate management service provider and bifurcating Dr. Robucci's interest in Robucci LLC so that he would be separately compensated for the use of his intangibles was obviously unreasonable. On the contrary, had it been more carefully implemented, it well might have been realized, at least in part. The problem for Dr. Robucci is that Mr. Carson's strategy for implementing his tax minimization goal was patently inadequate to the task, a fact that should have been obvious to Dr. Robucci and have prompted him to either question Mr. Carson or seek a second opinion.** Although Robucci P.C. and Westsphere were properly formed under Colorado law to carry out legitimate corporate functions, **the fact that they were nothing more than empty shells, devoid of property, personnel, or actual day-to-day activities, i.e., of substance, should have sent warning signals to Dr. Robucci that those corporations were not effecting any meaningful change in the prior conduct of his medical practice.** Although Dr. Robucci may have had some vague notion that he was acting on behalf of Westsphere when performing services other than actual patient care, there is little or no evidence as to the precise nature of those services, the time Dr. Robucci may have spent performing them, or their value. In short, there is no support for any charge from Westsphere to Robucci LLC for such services or for the claim that Dr. Robucci was wearing a Westsphere hat when he performed them. For Dr. Robucci, aside from signing a raft of documents and shifting some money between two new bank accounts, it was business as usual. Moreover, although he might have been justified in relying upon Mr. Carson's expert valuation of his intangibles as the basis for the

85-10 split between his limited and general partnership interests in Robucci LLC, the lack of any formal transfer of those intangibles to Robucci LLC should have been cause for concern. Under those circumstances, it was incumbent upon Dr. Robucci, even though he was not a tax professional, to question the efficacy of the arrangement that purported to minimize his taxes while effecting virtually no change in the conduct of his medical practice. By not doing so, Dr. Robucci failed to exercise the ordinary business care and prudence required of him under the circumstances.

- ii. ***Renkemeyer, Campbell & Weaver, LLP v. Commissioner***, 136 T.C. No. 7 (2011), involved a limited liability partnership (LLP), carrying on a tax law practice. Three of the law firm's partners were attorneys performing legal services. The fourth partner was an S corporation owned by a tax-exempt ESOP whose beneficiaries were the law firm's three attorney partners. The S corporation's business activities primarily involved the purchase, sale, and rental of real estate. The three attorney partners each had a one-third capital interest and a 30% profits and loss interest in the law firm. The S corporation had a 10% profits and loss interest in the law firm. Approximately 99% of the law firm's net business income for its tax year was derived from legal services rendered by the three attorney partners.

The law firm allocated 87.557% of its net business income to the S corporation. Because the S corporation was solely owned by the ESOP, it paid no income or self-employment tax with respect to its distributive shares from the LLP. The LLP did not report any of its income as net earnings from self-employment. In 2005, the partnership recapitalized to provide for a general managing partner interest (a GP interest) and an investing partner interest (an LP interest). The three individual partners each had a 1% GP interest and a 32% LP interest (The S corporation was no longer a partner). Allocations were generally limited to a partner's collections and no self-employment tax was paid on allocations to the LP interests.

IRS determined that the 2004 "special allocation" did not reflect economic reality under §704(b)(2) and consequently reallocated the law firm's net business income to its partners on the basis of each partner's profits and loss interest. IRS further determined that the three attorney partners' distributive shares of the law firm's net business income for tax years 2004 and 2005 were net earnings from self-employment subject to tax on self-employment income.

The issue of the special allocation was easy. If the partnership agreement is silent, the partners share per capita. No partnership agreement for 2004 was introduced into evidence. The Tax Court then turned to (a) The partners' relative capital contributions to the partnership; (b) the partners' respective interests in partnership profits and losses; (c) the partners' relative interests in cashflow and other nonliquidating distributions; and (d) the partners' rights to capital upon liquidation. None of these supported the special allocation.

The much more significant issue was the "limited partner" self-employment tax issue discussed below.

#### F. "Limited Partner"

- i. ***Renkemeyer***

1. §1402(a)(13) bars<sup>65</sup> self-employment treatment of a limited partner's distributive share of income or loss. The taxpayers in *Renkemeyer* argued that the attorneys' "limited partner" interests "share characteristics of those of a limited partner in a limited partnership because (a) their interests are designated as limited partnership interests in the law firm's organizational documents, and (b) his and Messrs. Campbell's and Weaver's interests in the law firm enjoy limited liability pursuant to Kansas law."
2. The Tax Court traced the tortured history of the lack of a definition of "limited partner" under §1402(a)(13) (proposed 1997 material participation regulations, Congress' temporary" bar of final regulations, advent of LLC's and LLP's)—
  - a. "Limited partner" is a technical term which has become obscured over time because of the increasing complexity of partnerships and other flowthrough entities as well as the history of section 1402(a)(13). We therefore must look to the legislative history for guidance.\*\*\* [T]he intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.

Aside from a nominal amount of income arising from recognition of certain pass-through income from RCGW, all of the law firm's revenues were derived from legal services performed by petitioner and Messrs. Campbell and Weaver in their capacities as partners. Petitioner and Messrs. Campbell and Weaver each contributed a nominal amount (\$110) for their respective partnership units. Thus it is clear that the partners' distributive shares of the law firm's income did not arise as a return on the partners' investment and were not "earnings which are basically of an investment nature."

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<sup>65</sup> Section 1402(a)(13) redefined a partner's self-employment income to exclude the distributive share of a *limited* partner, other than Section 707(c) "guaranteed payments" to such a partner for services actually rendered to, or on behalf of, the partnership. Social Security Amendments of 1977, Pub. L. No. 95-216, §313(b), 91 Stat. 1509 (1977); H.R. Rep. No. 95-702, pt. 1, 95th Cong. 2<sup>nd</sup> Sess. 40 (1977)(to the extent those payments are established to be in the nature of remuneration for those services)/. See §1402(a)(13). A guaranteed payment is a payment to a partner for services or the use of capital to the/ extent determined without regard to the income of the partnership. See §704(d). See *Pratt v. Commissioner*, 64 T.C. 203 (1975), *rev'd on other grounds*, 550 F.2d 1023 (5th Cir. 1977)(holding payments based on partnership gross, rather than net, income are not guaranteed payments); *contra* Rev. Rul. 81-300, 1981-2 C.B. 143.

**Instead, the attorney partners' distributive shares arose from legal services they performed on behalf of the law firm.**

3. *Renkemeyer* is consistent with a number of PAL cases which rejected automatic passive loss treatment to members in LLC's and LLP's who materially participated in the entity's business activities.<sup>66</sup>

**G. Roads Not Yet Completely Travelled**

- i. The Tax Court in *Robucci* did not address the IRS' alternative arguments because it found that the 2 corporations were shells.
  1. "(1) if the corporations are respected for Federal income tax purposes, he may allocate all of their income and expenses and all of the income and expenses of Robucci LLC to Dr. Robucci under the authority of sec. 482, and (2) if the corporations are respected for tax purposes and respondent's application of sec. 482 is deemed arbitrary and capricious, respondent may allocate all of the income and expenses of the corporations and Robucci LLC to Dr. Robucci under sec. 269A.
- ii. Although not yet applied in the under compensated S shareholder for wage tax purposes context, substantial analogous authority exists in the sole shareholder professional corporation context that the arm's length charge of a professional, who has incorporated for his or her services, under §482 (providing IRS power to reallocate income between controlled entities) is the amount including fringe benefits that he or she would have earned absent incorporation.<sup>67</sup> This suggests that IRS could determine under §482 that the arm's length compensation that should have been charged by the S Corporation shareholder for his or her services is essentially equivalent to what he or she would have received absent incorporation because that is what an uncontrolled taxpayer could demand and obtain.<sup>68</sup> That amount would, under §482, constitute imputed compensation income to the shareholder employee and an imputed deduction to the corporation.<sup>69</sup> That imputed compensation would constitute wages to the S corporation shareholder-employee. I agree with Professor Schwidetzky that under a substance over form analysis absence of a distribution of S corporation earnings should not affect the issue of under compensation of an active

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<sup>66</sup> Stewart Karlinsky, *Self-Employment Taxes and PALs: The Case of LLCs*, 132 Tax Notes 1391 (Sept. 26, 2011).

See, e.g., *Garnett v. Commissioner*, 132 T.C. 368 (2009).

<sup>67</sup> See John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey, the Stars Might Lie But the Numbers Never Do,"* 78 TEX. L. REV. 885, 932-33 (2000).

<sup>68</sup> *Keller v. Commissioner*, 77 T.C. 1014, 1025 (1981)(§482 issue is whether professional corporation and professional would have entered into their financial relationships had they been unrelated parties dealing at arm's length." [O]ne would expect petitioner, in an arm's-length transaction with an unrelated party, to have bargained for a total compensation package which would approximate the amounts he previously received as a sole proprietor. One would similarly expect that petitioner's total compensation would also reflect any increase in MAL and MAL, Inc.'s earnings over and above the pre-incorporation years."), *aff'd*, 723 F.2d 58 (10th Cir. 1983). Lee, *Business Tax Entities*, *supra* note 67; Walter D. Schwidetzky, *Integrating Subchapters K and S, Just Do It*, 62 TAX LAW. 749, 799-800 (2010) applies similar reasoning to argue that in a closely held services S corporation, all of the income of the S corporation is attributable to her services. Therefore, normally reasonable compensation is all of the net income of the S Corporation. There still is a conceptual problem of return on intangible capital.

<sup>69</sup> §1.482-1; *Haag v. Commissioner*, 88 T.C. 604 (1987)(court allocated payroll taxes as part of Section 482 allocation of adjustments to under-compensation professional).

shareholder,<sup>70</sup> but it probably does.

#### IV. Where do we go from here?

##### A. New Ventures

- i. I think that in the case of any S corporation recently electing S status and thus receiving the IRS S election acceptance form clearly setting out the requirement of paying reasonable compensation and the recharacterization power of the Service,<sup>71</sup> which nevertheless pays zero or low compensation to an officer performing more than minor services, manifests an intent to not comply with the reasonable compensation for services requirement, i.e., evade wage taxes.

##### B. Existing Entities

- i. IRS should send “hard” letters at least to all S corporations controlled by a single shareholder reporting on Form 1120S business income above a specified level, say \$100,000, while reporting no compensation paid to officers;<sup>72</sup> setting forth in some detail (1) the duty of an S corporation to pay reasonable compensation to officers performing more than minor services, (2) the uniform judicial (a) finding of no reasonable basis not to treat as employees officers performing more than minor services for an S corporation and receiving remuneration in any form, and (b) re-characterizing all distributions to her or him in whatever form as compensation subject to wage taxes; (3) and warning the taxpayer that if the S corporation and its controlling shareholder continue this pattern of evading wage taxes in subsequent returns, negligence and possibly, at least civil, fraud penalties may be imposed; and suggesting an amended return; and (4) further warning that shifting in subsequent years to paying a small amount of profits as officer compensation or shifting to another entity in order to attempt to continue evading wage taxes would appear badges of (at least civil) tax fraud<sup>73</sup> for which there is no statute of limitations.

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<sup>70</sup> Schwidetsky, *supra* note 68 at n.271 (In these cases, the courts often focused on distributed earnings, and typically most or all of the earnings were distributed. Distribution should not change the analysis. If the S corporation earnings are indeed best classified as compensation to the shareholder-employees, whether or not they are distributed in a given year should not change the answer.”).

<sup>71</sup> CP 261, *Sample Contents of Notice of Acceptance as an S-Corporation*, available at <http://www.irs.gov/individuals/article/0,,id=128518,00.html> (“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 revenue ruling 74-44 states that the Internal Revenue Service (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. The IRS may also re-characterize distributions other than dividend distributions as salary. This position has been supported in several recent court decisions”). See generally James A. Fellows & John F. Jewell, *S corporations and salary payments to shareholders: a major issue for the IRS; corporate taxation*, 76 [New York State] CPA Journal 46 (May 2006).

<sup>72</sup> Form 1120S line 7 calls for entering the total compensation of all officers paid or incurred in the trade or business activities of the corporation...

<sup>73</sup> *Fred R. Esser, P.C. v. United States*, 750 F. Supp. 421 (D Ariz. 1990)(S corporation loaned attorney shareholder money on weekly basis and at year end “paid” dividend equal to net taxable income which shareholder left in corporation to pay back loans he received during the year; “employer should not be permitted to evade FICA and FUTA by characterizing all of an employee’s remuneration as something other than ‘wages.’”), citing *Joseph Radtke, S.C. v. United States*, 712 F. Supp. 143, 146 (E.D. Wis.1989)(“where the corporation’s only director had the corporation pay himself, the only significant employee, no salary for substantial services -- ... Mr. Radtke’s

TIGTA Russell George, however, in the 2005 Senate Finance Committee Hearings on “Social Security: Achieving Sustainable Solvency” questioned whether “education” was the issue as to under compensation of S corporation officers to evade wage taxes.<sup>74</sup>

- ii. A more bold alternative administrative technique would be to send to high business income, no officer compensation, single shareholder-controlled S corporations a Correspondence Audit (letter) requesting information as to identity of officers; services performed by officers and/or controlling shareholder; identification of primary generators of the S corporation’s business income; and amounts of distributions to officer-shareholders in any form (e.g., dividends, loans, withdrawals, royalties or rents). Then if such Correspondence Audits are ignored (as probably half will be), IRS should send to the taxpayer deficiency notices or notices of employee status determination<sup>75</sup> and amounts of wage taxes due on the assumption that all business profits (or any distributions) constitute wages for services.
- iii. Additionally any return preparers of more than some floor number of 1040S returns for such identified S corporations<sup>76</sup> should also be sent similar warning letters with the additional warnings of adding and abetting tax fraud; and

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‘dividends’ were in fact ‘wages’ subject to FICA and FUTA taxation. His ‘dividends’ functioned as remuneration for employment. ....An employer should not be permitted to *evade FICA and FUTA* by characterizing *all* of an employee’s remuneration as something other than ‘wages.’”(emphasis supplied), *aff’d*, 895 F.2d 1196 (7<sup>th</sup> Cir. 1990).

<sup>74</sup> 2005 Senate Finance Hearing, *supra* note 10 at 39. See also TIGTA, WHILE EXAMINATIONS OF HIGH-INCOME TAXPAYERS HAVE INCREASED, THE IMPACT ON COMPLIANCE MAY BE LIMITED 2 (2006-30-105 Jul. 25, 2006); TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, SIGNIFICANT CHALLENGES EXIST IN DETERMINING WHETHER TAXPAYERS WITH SCHEDULE C LOSSES ARE ENGAGED IN TAX ABUSE (2007-30-173 Sept. 7, 2007)(First, IRS issued on its web site a “Factsheet” reminding taxpayers in filling out schedule C to follow appropriate guidelines when determining whether an activity is a business or a hobby (an activity not engaged in for profit). When that didn’t work, SB/SE in a 2005 research project sent out letters to individuals with potentially tax-abusive home-based “businesses” claiming Schedule C losses. While some taxpayers filed amended returns, the overall response rate was low (around 50 percent as in the 2006 TIGTA report as to 2004); SB/SE concluded that sending letters was not effective. In 2003 in limited testing SB/SE undertook Correspondence Audits of potential hobby loss returns. Out of 148 returns SB/SE disallowed the Schedule C losses as hobby losses of 103 or 69.6 percent. IRS collected the assessed increase in taxes from 92 percent of the taxpayers with disallowed losses. This looked like success, but TIGTA reviewed the accounts of the taxpayers with the disallowed losses for the years 2002-05 and found 51 percent continued to claim Schedule C losses from the activities in succeeding years after the 2002 tax year returns filed in 2003. Based on these test results, IRS “believes working the hobby loss issue through correspondence examination is not productive because the multiple contacts with taxpayers increased the amount of time needed to complete the examinations.” TIGTA determined that the universe of taxpayers who potentially avoid taxes by deducting hobby losses (Schedule C losses for 2002 through 2005) for 2005 was 1,483,246 taxpayers, many with significant income from other sources; 1,076,796 (73%) of these individuals had their tax returns prepared by tax practitioners. Based on their Tax Year 2005 income levels, TIGTA estimated that 1,203,175 of that universe of taxpayers potentially avoided paying \$2.8 billion in income taxes).

<sup>75</sup> Whether the Service must issue a Notice of Determination of Worker Classification (NDWC) and provide the taxpayer with written notice of the provisions of Section 530 before commencing such an audit of an S corporation and a controlling officer performing more than minor services, receiving a distribution in any form and reporting no officer compensation is a contentious issue..

<sup>76</sup> YK1 Link Analysis Tool Extracts data from an Oracle database that contains selected information from the Individual and Business Master File Returns Transaction Files. The application uses partnership data to show how gains and losses flow through and across all related entities

egregious cases should be referred to the Office of Professional Responsibility for sanctioning.<sup>77</sup> This initiative should be widely publicized.

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<sup>77</sup> Unofficial Transcript is Available of IRS Hearing on Practice Standards for Tax Return Preparation, 2010 TNT 197-23 (Oct. 13, 2010) (preamble to the proposed regulations notes that the standards in section 10.34(a) with respect to tax returns are being repropoed to provide broader guidelines that are more appropriate for professional ethic standards with a particular focus on tax shelters. A "tax shelter" is defined by reference to §6662(d)(2)(C)(ii), which describes a tax shelter as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a "significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax.").