

Compensation Paid by S Corporations to Shareholder-Employees

The issue: compensation is subject to payroll taxes; K-1 passthrough profits are not. FICA and FUTA taxes are imposed on compensation paid by an S corporation to its employees, including shareholder employees. But, S corporation profits passed through to shareholders, whether they are employees or not, are not subject to FICA or FUTA tax.

The “unreasonable” vs. “more reasonable” problem. If the S corporation reasonably selects compensation at the low end of the compensation spectrum and the IRS auditor reasonably selects compensation at the high end of the same spectrum, how does the court decide which party is correct? Historically, the IRS asked courts to decide if the amount of compensation was *unreasonable*. Prior to *Watson (David E. Watson, P.C. vs US (8th Cir.) 11-1589, 668 F3d 1008, Feb. 21, 2012; US District Court, S.D. Iowa, Central Div.; 4:08-cv-442, Dec. 23, 2010)*, the courts were not asked to decide if the taxpayer’s amount or the IRS’s amount is *more reasonable*.

Years of S Corporation Court Cases

Salary Claimed on Return Deemed Unreasonable (1-3 yrs)	Case
\$0, \$0, \$0	<i>Superior Proside, Inc.</i> 2004-1 USTC ¶50,146
\$0, \$0, \$0	<i>Nu-Look Design, Inc.</i> 2004-1 USTC 50,138
\$0	<i>B. M. Cohen v. Comm.</i> , TCM 2003-42
\$0, \$0, \$0	<i>Water-Pure Systems, Inc. v. Comm.</i> , TCM 2003-53
\$2,000, \$0, \$0	<i>Wiley L. Barron, CPA</i> , TCS 2001-10
\$0, \$0	<i>Veterinary Surgical Consultants v. Comm.</i> , TCM 2003-49
\$24,000, \$24,000	<i>David E. Watson, P.C. v. US</i> , 2011-1 USTC ¶50,443
\$2,400	<i>Patrick M. Herbert, pro se. v. Comm.</i> , TCS 2012-124
\$0, \$0	<i>Glass Blocks Unlimited v. Comm.</i> , TCM 2013-180
\$0	<i>Sean McAlary Ltd. Inc. v. Comm.</i> , TCS 2013-62
\$0, \$0	<i>Scott Singer Installations, Inc. v. Comm.</i> , TCM 2016-161

IRS Can Recharacterize, but to What Extent? To the Extent of Reasonable Compensation!

In *Joseph Radtke, S.C. v. United States*, (712 F. Supp. 143 (E.D. Wisc. 1989), aff’d 895 F.2d 1196 (7th Cir. 1990)), an attorney/president/sole shareholder took money by having the board declare a dividend and writing a corporate check to himself. The IRS successfully argued that since Radtke performed substantial services and did not receive *reasonable compensation* for such services other than “dividends,” these dividends constituted “wages.” The court ruled that “an employer should not be permitted to evade FICA and FUTA by characterizing *all* (the court’s emphasis) of an employee’s remuneration as something other than ‘wages.’” The *Radtke* case introduces the “reasonable compensation” standard to S corporations and intriguingly (to the IRS’s detriment)³³ ties the C and S corporation reasonable compensation cases together.

³³ In C corporation reasonable compensation cases, the IRS argues that the compensation is unreasonably high, whereas in S corporation reasonable compensation cases, the IRS argues that the compensation is unreasonably low, a difficult balancing act when the definition of “reasonable” is the same for both types of corporations. What prevents taxpayers from using the IRS’s C corporation arguments against it in an S corporation case?