Drop-in Article

S Corporation Officers Performing Services Are Employees; Pay Is Wages

The Internal Revenue Service wants tax professionals and small business owners to understand the law regarding corporate officers who perform services. By law, officers of corporations are employees for employment tax purposes and their compensation is wages. The IRS has identified that some S corporations, in an effort to avoid employment taxes, are improperly treating payments for services to officers as "corporate distributions" instead of salaries. This attempt to characterize officers as other than employees does not work. This article discusses the tax law and recent court cases related to this issue.

The Internal Revenue Code establishes that a corporate officer is an employee of the corporation for federal employment tax purposes. Code sections 3121(d)(1), 3306(i), and 3401(c) specifically define officers of corporations as employees for FICA (Social Security and Medicare), FUTA (Unemployment), and federal income tax withholding purposes.[1]

Treas. Reg. section 31.3121(d)-1(b) provides a limited exception to the statutory definition:

> Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is considered not to be an employee of the corporation.

Over the past few years, the Tax Court has decided several employment tax cases holding that S corporation officers are employees.[2]

In Veterinary Surgical Consultants, PC v. Commissioner, 117 T.C. 141 (2001) (Veterinary Surgical I), aff'd consol., Yeagle Drywall Co. v. Commissioner, 54 Fed. Appx. 100 (3rd Cir. 2002), 2003-1 U.S.T.C. ¶ 50141 (3rd Cir. 2002), 90 AFTR ¶ 7744 (3rd Cir. 2002), cert. denied, 1235 S. Ct. 2621 (2003), a veterinarian was president and sole shareholder of an S corporation and generated all of the corporate income through his consulting and surgical services. He was also the only individual who performed services for the corporation. The corporate entity claimed the president received no salary for services performed and argued that amounts paid to the president were distributions of corporate net income, rather than wages. In finding that the president provided substantial services to the corporation and was thus an employee and therefore the amounts distributed to him were actually wages subject to employment taxes, the Tax Court stated:

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[1] Also see Treasury Regulation sections 31.3121(a)-1(b) and (c), 31.3306(b)-1(b) and (c), and 31.3401(a)-1(a)(1) and (2).

[2] Cases decided under IRC § 7436.

> …[T]he characterization of the payment to [the president] as a distribution of petitioner's net income is but a subterfuge for reality; the payment constituted remuneration for services performed by [the president] on behalf of petitioner. An employer cannot avoid federal employment taxes by characterizing compensation paid to its sole director and shareholder as distributions of the corporation's net income, rather than wages. Regardless of how an employer chooses to characterize payments made to its employees, the true analysis is whether the payments represent remuneration for services rendered.

The Tax Court rejected the corporation's arguments regarding relief under section 530 of the Revenue Act of 1978,[3] finding that the corporation had no reasonable basis for treating the president as other than an employee. The Tax Court and the 3rd Circuit upheld the IRS's position that the president was an employee of the S corporation and the corporation was liable for federal employment taxes.

Similarly, in Mike J. Graham Trucking, Inc. v. Commissioner, T.C. Memo 2003-49, the Tax Court held that the president of an S corporation who was also the majority shareholder was an employee. In Graham Trucking, the president drove a truck, solicited business, ordered supplies, entered into agreements, oversaw finances, and generally managed the corporation. The corporation did not make regular payments to the president for his services. Rather, the president took funds from the corporation's bank account as needs arose and/or paid personal expenses for himself and his family from the account. The Tax Court held that the president performed more than minor services and received remuneration for those services. The Tax Court rejected the corporate entity's arguments regarding relief under section 530, finding that the corporation had no reasonable basis for treating the president as other than an employee.

In each of five other recent opinions listed below, the Tax Court held that the president and sole (or in one case 50%) shareholder of an S corporation, who performed all the services provided by the corporation, was an employee of the corporation. Accordingly, the amounts the president received from the corporation were wages. In each case, the Tax Court also found that the corporation was not entitled to relief under section 530 because it had no reasonable basis for treating the officer as other than an employee.

- Veterinary Surgical Consultants, P.C. v. Comm., T.C. Memo 2003-48 (same veterinarian as in Veterinary Surgical I – see above cited case)
- Superior Proside, Inc. v. Comm., T.C. Memo 2003-50 (siding contractor & remodeling service)
- Specialty Transport & Delivery Services, Inc. v. Comm., T.C. Memo 2003-51 (trucking business)
- Nu-Look Design, Inc. v. Comm. T.C. Memo 2003-52 (home improvement company)

[3] Section 530 of the Revenue Act of 1978 provides relief from employment taxes for taxpayers who meet certain requirements, including a reasonable basis.

- Water-Pure Systems, Inc. v. Comm., T.C. Memo 2003-53 (sales of water purification systems)

Other courts have also recognized that an officer of a corporation is an employee for employment tax purposes.

In Spicer Accounting, Inc. v. United States, 1988 U.S. Dist. LEXIS 16891 (D. Idaho 9-1-88), aff'd 918 F. 2d 90 (9th Cir. 1990), an accountant, who was the president and owner of an S corporation, sued for a refund of the employment taxes paid for the president/shareholder of the S corporation. The president provided all of the accounting services for the corporation and signed all tax returns completed by the corporation. The accountant did not have an employment contract with the corporation. The accountant did not receive any salary from the corporation, but received "dividends". The court found that the accountant provided substantial services that were essential to the corporation, he was an employee (not an independent contractor), and the dividends were actually wages subject to employment taxes.

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), another refund suit, an attorney/president/sole shareholder took money by having the board declare a dividend and writing a corporate check to himself. The court held the "dividends" were wages and that the employer could not be permitted to evade employment taxes by characterizing remuneration as something other than wages.

These cases emphasize the courts have consistently held that S corporation officer/shareholders who provide more than minor services to their corporation and receive remuneration are employees whose compensation is subject to federal employment taxes. For more information, visit www.irs.gov/smallbiz.