

S Corporation Officers Compensation Treated as Corporate Distributions.

In an effort to avoid employment taxes, some S Corporations are improperly treating officer compensation as a corporate distribution instead of wages or salary. By law, officers are employees of the corporation for employment tax purposes and compensation they receive for their services is subject to employment taxes.

The IRS encourages employees to report any concerns that an employer is failing to properly withhold and pay federal income and employment taxes.

Taxpayers can contact the IRS at 800-829-1040 or report suspected tax fraud by calling 800-829-0433.

(from the SSA/IRS "REPORTER" Newsletter of Summer 2004)

Subchapter S Corporations and Employment Taxes: A Reminder About Reasonable Compensation Rules

On February 12, 2001, IRS issued a consumer alert regarding schemes in which employers seek to avoid withholding federal income tax and employment taxes from wages paid to their employees. Joe Kehoe, Commissioner of the IRS Small Business and Self-Employed Division, stated, "The law is crystal clear that income and employment taxes must be paid. Evading employment taxes can have serious consequences. Employers may be subject to criminal and civil sanctions for willfully failing to pay employment taxes."

One tactic appearing to grow in use to avoid payment of employment taxes involves owners/shareholders of Subchapter S Corporations who reduce or eliminate their salaries and replace the amounts with dividends since distributions of profit are not subject to employment taxes.

Practitioners and Subchapter S shareholders need to be aware that Revenue Ruling 74-44 states that the IRS will re-characterize small business corporation dividends paid to shareholders as salary when such dividends were paid to the shareholders in lieu of reasonable compensation for services.

The courts have backed up the IRS determination and ruled that dividends can be re-characterized, regardless of the stated intention of the S corporation, if the shareholders have performed services. Corporations **MUST** consider the reasonable compensation to which the shareholders are entitled.

You may ask, "How much is reasonable compensation?" The courts have considered such factors as the nature and scope of the shareholder's work, the corporation's compensation policy for all employees, and the prevailing rate of compensation for comparable positions in comparable companies.

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