

AN ALERT FROM THE BDO COMPENSATION & BENEFITS TAX PRACTICE

# BDO KNOWS: COMPENSATION & BENEFITS



## ► SUBJECT

## DISTRIBUTIONS TO S CORPORATION SHAREHOLDER RECHARACTERIZED AS WAGES SUBJECT TO PAYROLL TAXES

Unreasonably low salaries paid by S corporations to shareholder-employees invite IRS audits, FICA tax assessments, interest, and penalties. A recent decision by the Court of Appeals for the Eighth Circuit adds to the overwhelming authority favoring the IRS recharacterization of S corporation distributions as wages.

## ► BACKGROUND

While wages paid to shareholder-employees of S corporations are subject to FICA taxes, distributions by S corporations are not. Thus, shareholder-employees have a significant tax savings opportunity by withdrawing funds from the S corporation in the form of distributions rather than wages.

The Service and courts have been hostile to abusive arrangements where shareholder-employees of an S corporation drew no salary (or unreasonably low salary) from the corporation, but arranged for the corporation to pay them distributions equal to the amount they would otherwise have received as reasonable compensation for services performed. The Service and the courts have recharacterized such distributions as wages, resulting in FICA tax assessments, interest, and penalties.

In a case where the *actual* payment of wages to the sole shareholder-employee of an S corporation was set at an unreasonably low level, the Service successfully recharacterized an additional portion of the S corporation distributions as wages subject to FICA taxes. The “deemed wages” were upheld by the district court and recently affirmed by the Eighth Circuit in *David E. Watson, P.C. v. United States*, 668 F.3d 1008 (8<sup>th</sup> Cir. 2012).

### CONTACT:

---

**ANDREW GIBSON**  
404-979-7106  
[agibson@bdo.com](mailto:agibson@bdo.com)

---

**PETER KLINGER**  
415-490-3214  
[pklinger@bdo.com](mailto:pklinger@bdo.com)

---

**CARL TOPPIN**  
212-885-8331  
[ctoppin@bdo.com](mailto:ctoppin@bdo.com)

---

**JOAN VINES**  
301-634-0250  
[jvines@bdo.com](mailto:jvines@bdo.com)

In *Watson*, the individual owned 100% of the stock of an S corporation that was a partner in an accounting firm. The individual shareholder received \$24,000 in salary while the S corporation received \$203,651 in profit distributions from the partnership for 2002. For 2003, the individual shareholder received \$24,000 in salary while the S corporation received \$175,470 in profit distributions from the partnership. The Service increased the wages to \$91,044 for each year and the court upheld the Service's assertions based on expert testimony determining reasonable compensation for a certified public accountant with credentials, experience, and responsibility similar to that of the individual shareholder.

## TAX PLANNING

The Eighth Circuit decision and other authorities favorable to the Service provide a clear warning against an abusive practice of decreasing wages paid by an S corporation to shareholder-employees with a corresponding increase in their distributions for the purpose of reducing FICA taxes. S corporations that have adopted or are contemplating this strategy should consider the reasonableness of the amount paid as wages. In non-abusive situations, where reasonable compensation has been paid to shareholder-employees, the Service may have difficulty successfully recharacterizing the distributions made to shareholder-employees as wages subject to FICA taxes.

Internal Revenue Manual section 4233.27 lists several factors for the IRS agents to consider in reasonable compensation cases, including: (1) nature of employee's duties; (2) employee's background and experience; (3) employee's knowledge of business; (4) size of business; (5) employee's contribution to the profit making; (6) time devoted by employee to the business; (7) economic conditions in general and locally; and (8) employee's amount of responsibility. Many of these factors have been taken into account in the decisions rendered by various courts that upheld the amount of the deemed wages asserted by the Service. S corporations should likewise consider these items when assessing the reasonableness of wages paid to shareholder-employees.

The Tax Practice at BDO is among the largest tax advisory practices in the United States. With 40 offices and more than 400 independent alliance firm locations in the United States, BDO has the bench strength and coverage to serve you.

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 40 offices and more than 400 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multinational clients through a global network of 1,118 offices in 135 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information, please visit: [www.bdo.com](http://www.bdo.com).

To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Material discussed in this tax alert is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

© 2012 BDO USA, LLP. All rights reserved. [www.bdo.com](http://www.bdo.com)