Characterizing and Quantifying Reasonable Compensation of S Corporation

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The Eighth Circuit recently issued its decision in the case of *David E. Watson, P.C. v. U.S.*, No. 11-1589 (8th Cir. 2/21/12), which dealt with the issue of determining reasonable compensation in a closely held S corporation for FICA tax purposes.

FICA taxes refer to those payroll taxes imposed on both employees and employers under the Federal Insurance Contribution Act. The Internal Revenue Service (the "IRS") has ruled that FICA taxes, which include both Social Security and Medicare taxes, are not payable on distributions from an S corporation. Consequently, S corporations may be tempted to characterize all or a portion of a shareholder-employee's compensation income as a corporate distribution.

To circumvent this issue, the IRS issued Revenue Ruling 74-44, 1974-1 CB 287, which asserts that the IRS may re-characterize dividend distributions to a shareholder-employee when such distributions are received in lieu of wages. Likewise, various courts, including the Tax Court, the Third Circuit, the Seventh Circuit and the Ninth Circuit, have held that where a shareholder-employee received no salary, a portion, if not all, of such shareholder-employee's dividend distribution was clearly compensation for services rendered.

Unlike prior case law, which generally dealt with a complete lack of remuneration, the present case involved the underpayment of wages to a shareholder-employee. David Watson ("Watson") was a certified public accountant with approximately 20 years of experience. Eventually, Watson became a 25% partner in a Des Moines based accounting firm (the "Firm") and transferred his partnership interest to an S corporation known as David E. Watson, P.C. (the "Corporation"). While Watson performed work solely on behalf of the Firm, it was the Corporation that employed him. In each of 2002 and 2003, the Corporation distributed approximately $24,000 to him as compensation. In addition to this salary, Watson, through the Corporation, received distributions from the Firm equal to $203,651 in 2002 and $175,470 in 2003. Watson was the sole shareholder, officer, director and employee of the Corporation.

After analyzing the salary and profit distributions to Watson, the IRS determined that the Corporation had underpaid certain FICA taxes for 2002 and 2003. The Corporation paid the delinquent tax, penalty and interest and sought a refund from the IRS. When the IRS denied the refund request, the Corporation sued the United States in district court. Citing the testimony of the government's compensation expert, the district court held that the market value of Watson's accounting services was approximately $91,044 per year, and it rendered a deficiency judgment against the Corporation for unpaid employment taxes, penalties and interest in the amount of $23,431.23. The Corporation appealed the district court's holding.

In a case of first impression, the Eighth Circuit addressed not only the classification of distributions to a shareholder-employee, but also the quantification of reasonable compensation and the factors to be considered in arriving at such quantification. Citing decisions of other circuits, the Court found that, while a reasonable compensation analysis is typically applied to income tax deduction issues, it is equally applicable to FICA tax cases. In looking to the substance of the parties' transaction, as opposed to the form of their transaction, the Court focused on Watson's 20 years of accounting experience, the 35 to 45 hours per week that he devoted to the Firm, the Firm's annual gross earnings of approximately $2 million in 2002 and $3 million in 2003 and the fact that a $24,000 annual salary was unreasonably low when compared to similarly situated accountants. Ultimately, the Court concurred with the district court's holding and affirmed that $91,044 per year was reasonable compensation given Watson's services to the Firm on behalf of the Corporation.

This case is highly relevant for S corporations with shareholder-employees. In determining the reasonableness of compensation paid to such shareholder-employees, S corporations should consider the following factors, as outlined in *Watson*: (i) the shareholder-employee's experience and training; (ii) the amount of time the shareholder-employee devotes to the business on a weekly basis; (iii) the gross earnings of the business; (iv) the amount paid to similarly situated employees in analogous industries; and (v) the fair market value of the shareholder-employee's services.

For more information about this topic, please contact the authors or any member of the Williams Mullen Tax Law Team.

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