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LAW OFFICES OF GARY R. WAITZMAN, L.L.C.

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District Court Says S Corp Dividends Can be Considered Taxable Wages

I wanted to inform you of a recent court decision that may affect your clients who own S corporations.

This summer, the U.S. District Court for the Southern District of Iowa Central Division determined that the characterization of funds disbursed by an S corporation to employees or shareholders should be based on whether the payments were made as remuneration for services performed.

Essentially, the court said that you can't lowball your "salary" and then accept dividends at a lower tax rate.

Why People Create S Corporations

For definition purposes, S corporations are corporations that elect to pass income, losses, deductions, and credits through to their shareholders for federal tax purposes.

Shareholders report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates.

Facts of the Case

In 1996, David E. Watson incorporated David E. Watson, P.C (DEWPC). DEWPC later elected to be taxed as an S Corporation, with Watson as sole shareholder, employee, director, and officer. In 2000–2002, he authorized his salary from DEWPC at $24,000 annually. In 2002 and 2003, DEWPC paid federal employment taxes on that amount.

However, in addition to his $24,000 in 2002, Watson received checks from DEWPC totaling $203,651, $118,159 of which was recorded as dividend distributions. In 2003, Watson received $221,577 in dividend payments. In both years, he worked 35 to 45 hours per week. His monthly living expenses exceeded his $2,000 monthly salary.

In 2007, the Internal Revenue Service assessed $48,519 in taxes, penalties and interest for the eight calendar quarters of 2002 and 2003. It determined that portions of the dividend distributions to Watson should be re-characterized as wages.

DEWPC later paid $4,064 toward these assessments but filed a claim for refund. The IRS denied the claim and DEWPC sued in district court.

Fast forward to 2010: the court sides with the IRS.

Action Step

If your client has an S corporation, this case serves as another reminder that paying shareholders reasonable compensation is necessary. Structuring a reasonable salary should include basing compensation on market rates in the business location for similar businesses. While striking a reasonable salary is a subjective exercise, using S corporation distributions remains a viable planning device.

Note: Both the House and Senate have bills pending that would further increase the tax law in this area.

As always, I hope this article has helped you and your clients. If you have a specific case or concern, please contact our office.

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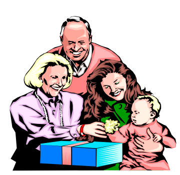

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