insights

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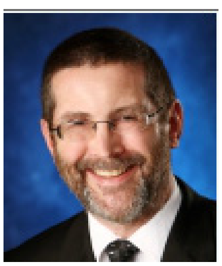
Recent Cases Highlight Importance of Observing Requirements and Restrictions Imposed on S Corporations

An S corporation is a popular form of business entity that is not itself subject to taxation. Instead, items of income, gain, loss and deduction "pass through" and are taxed directly to the corporation's shareholders. As a result dividend distributions from an S corporation to shareholders are not subject to tax. In contrast, a regular C corporation is itself subject to tax at the corporate level, and then dividend distributions from the corporation are subject to tax at the shareholder level.



By Thomas A. Cotter

Given the considerable benefit of being subject to only one level of taxation, the IRS strictly enforces the statutes, regulations and other laws applicable to S corporations. Two recent cases highlight this and illustrate that S corporation shareholders must exercise caution in structuring the ownership and operation of the corporation if tax benefits are to be preserved.
The first of these cases involved the issue of whether compensation paid to the shareholder/employees of an S corporation was reasonable. *David E. Watson, PC v. U.S.*, 668 F.3d. 1008 (8th Cir. 2012). Generally speaking, it is preferable to receive cash distributions from an S corporation as a shareholder dividend rather than as compensation for services, because the income supporting the dividend is not subject to employment taxes such as Social Security, Unemployment and Medicare Tax. As a result, shareholder/employees have an incentive to minimize compensation as employees and instead receive cash from the corporation in the form of dividends. Knowing this, when auditing an S corporation, the IRS will review compensation paid to shareholder/employees to ensure that the compensation is reasonable based on such factors as the qualifications and experience of the shareholder/employee, the nature and amount of the services performed for the corporation, the profitability of the corporation at issue and the amount of compensation paid to similarly situated employees who are not shareholders in a position of control over their employer-corporation. If the IRS finds that compensation paid is not reasonable, it has the power to recharacterize an appropriate amount of the dividends paid to a shareholder/employee as compensation for services and subject such amount to employment tax.

Watson involved just this type of situation. The taxpayer in question was an accountant and shareholder in a professional corporation with other accountants. The corporation had elected to be taxed as an S corporation. During 2002 and 2003, the corporation paid the taxpayer an annual salary of $24,000. The corporation paid the taxpayer $203,651 in dividends in 2002, and in 2003 it paid the taxpayer $175,470 in dividends. The IRS brought in one of its experts to review whether the compensation paid to the taxpayer for his services was reasonable under the circumstances. The expert reviewed several accountant compensation studies, relying in particular on one prepared by the American Institute of Certified Public Accountants. The latter survey indicated that an owner/employee would have received a total of compensation and return on investment of approximately $176,000 annually during the years in questions. The same survey indicated that a non-owner employee with similar experience would have earned approximately $70,000 in compensation. However, such an employee would on average have a billing rate 33% lower than a comparable owner-employee. Thus, the IRS expert increased the $70,000 compensation figure by 33% and arrived at a reasonable compensation figure for the taxpayer of $91,000 per year for 2002 and 2003, meaning an additional $67,044 was subject to employment tax.

The taxpayer argued that there is no statute, regulation or rule requiring that an employer pay a minimum amount of compensation for tax purposes. As such, what mattered was the intent of the corporation in making payment to the taxpayer. Since it intended to pay $24,000 in compensation, that was the amount that should be subject to employment tax. The court disposed of this argument by citing to a considerable body of case law confirming that the Internal Revenue Code is intended to tax the substance, not the form of the transaction. It was necessary to dig deeper and tax the true nature of a transaction rather than allow self-serving labels to control the outcome. This meant determining what a similarly-situated employer would reasonably be expected to pay a similarly-situated employee in an arm's length situation. The court found the IRS expert's analysis of this question persuasive and ruled in favor of the IRS.

While what constitutes "reasonable compensation" can be subject to debate, the types of shareholders that are eligible to hold S corporation stock is not. The Internal Revenue Code limits eligible shareholders to individual U.S. citizens and residents, domestic estates, certain trusts and certain tax-exempt entities. Notwithstanding these relatively well-defined categories of eligible shareholders, the 9th Circuit Court of Appeals was recently called upon to determine whether a Roth IRA may hold S corporation stock. *Taproot Administrative Services, Inc. v. Commissioner*, ___ F.3d ____, Dkt. No. 10-70892 (9th Cir. March 21, 2012). This question is a critical one because if S corporation stock is transferred to an ineligible shareholder, the S corporation's status as such immediately terminates and it is taxed as a C corporation. Unfortunately, for the Roth IRA shareholder in *Taproot*, the court held that it was not eligible to hold S corporation stock and therefore the corporation was not entitled to S corporation status.

In *Taproot* the corporation in question was created in 2002 and all of its shares were from the outset held in a custodial Roth IRA. A Roth IRA is similar to a traditional IRA in that income and gains recognized by a Roth IRA are not subject to tax. However, unlike a traditional IRA, a Roth IRA is funded with after-tax contributions and distributions received from it are not subject to tax. The taxpayer who was the owner and beneficiary of the Roth IRA argued that it should qualify as an S corporation shareholder on one of two grounds: (1) it should be viewed as a "grantor" trust, which is one of the types of trusts that is an eligible S corporation shareholder under the Internal Revenue Code or (2) that as the individual beneficiary of a custodial account that also was a Roth IRA the taxpayer should be considered the owner of the shares for purposes of determining eligibility for S corporation status.

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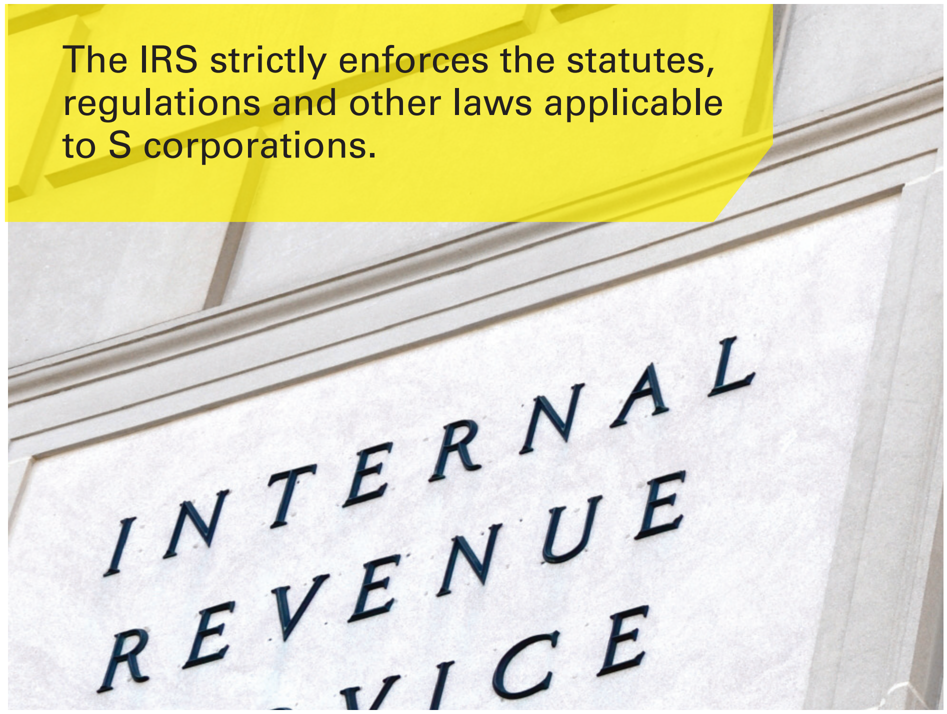

A "grantor" trust is a specific type of trust that is essentially disregarded for income tax purposes under the Internal Revenue Code. All of the assets held by a grantor trust are treated as if they are owned directly by the individual grantor who created or transferred property to the trust. Thus a grantor trust is not recognized as a separate entity for income tax purposes. Given this, the Internal Revenue Code allows a grantor trust to hold S corporation stock so long as the individual who is treated as the owner of the trust assets is qualified to hold S corporation stock. The taxpayer argued that a Roth IRA should be given the same treatment and the taxpayer should be treated as owning the Roth IRA assets. Since the taxpayer qualified to hold S corporation stock, it followed that the corporation in question should be accorded S corporation status.

Nearly 20 years ago the IRS issued a Revenue Ruling that concluded a traditional IRA was not an eligible S corporation shareholder in the same manner as a grantor trust. The IRS' rationale was that the person who was treated as the owner of a grantor trust's assets was taxed directly on income from the S corporation just as if such person owned the stock. In contrast, the owner of a traditional IRA was not taxed on income from the IRA. It was a separate, tax-exempt entity for income tax purposes. Based on the same rationale, the IRS argued that a Roth IRA should not be eligible to hold S corporation shares on the premise that it was a grantor trust. The court agreed, noting that both traditional and Roth IRAs were expressly created by Internal Revenue Code provisions that gave them existence separate from their owners, while grantor trusts were expressly denied an existence separate from their owners.

Turning to the argument that the individual beneficiary of a custodial Roth IRA should be treated as the owner of the Roth IRA, the court noted that the Treasury Regulations did provide that a person for whom stock is held by a guardian, nominee, custodian or agent is considered to be the shareholder for S corporation purposes. However, the court again reasoned that intent of the regulation was to tax S corporation income to the true, beneficial owner of the shares. So long as the true beneficial owner was eligible to hold S corporation stock, this was consistent with the restrictions on ownership imposed by the Internal Revenue Code. According a custodial Roth IRA the same treatment, on the other hand, would frustrate such ownership restrictions in that S corporation income would be received by the Roth IRA tax free as an entity separate from its owner even thought it held its assets as a custodian for the owner.

The most powerful evidence, however, against both of the taxpayer's arguments that the Roth IRA was eligible to hold S corporation shares lay in Congressional action on related matters over the past several years. The court noted that in 2004 Congress enacted a very narrowly crafted provision that allowed traditional and Roth IRAs to hold shares in S corporation banks without disturbing a bank's S corporation status. Prior to that, in 1999, Congress had directed the Comptroller General to conduct a study of possible revisions to the rules governing S corporations, including permitting shares to be held by IRAs. Congress would not have needed to pass the 2004 legislation, nor would it have directed an evaluation of whether IRAs should be allowed to own S corporation shares, if its intention had been to allow Roth IRAs to own S corporation shares in the first place. As such, the court concluded the Roth IRA was not an eligible S corporation shareholder and the corporation was therefore taxable as a C corporation from the date of its creation.

Both *Watson* and *Taproot* are examples of S corporation shareholders who did not take adequate care to follow the rules imposed on such corporations in light of their preferential tax treatment. They serve as a useful reminder that S corporation shareholders should consider and evaluate the tax consequences of various actions taken in managing the ownership and operation of the S corporation's business affairs.