

ACTION ON DECISION

Subject: Scott Singer Installations, Inc. v. Commissioner, T.C. Memo. 2016-161

Issue: Whether Taxpayer's payment of personal expenses on behalf of its sole shareholder-corporate officer constitutes wages subject to Federal employment taxes.¹

Discussion: Taxpayer, an S corporation, operated a retail store for recreational vehicle (RV) parts and engaged in the business of servicing, repairing, and modifying RVs. Taxpayer also sold and installed cabinets used in the construction of homes.

Scott Singer (Mr. Singer) was the sole shareholder and only corporate officer of Taxpayer, serving as president. Mr. Singer worked full-time performing substantial activities on behalf of Taxpayer, including: selling, ordering, and installing cabinets; providing customer service, such as preparing invoices and handling complaints; performing technician services on RVs; ordering and selling RV parts and supplies; and managing employees and signing checks.

Taxpayer was initially profitable, but business began to decline in 2008. From 2006 to 2011, Mr. Singer personally advanced funds to Taxpayer from various sources and also charged business expenses to personal credit cards. Taxpayer reported these advances as loans from shareholder on its general ledgers and its annual corporate income tax returns. However, there were no promissory notes for the advances between Mr. Singer and Taxpayer, nor any other features – such as a maturity date, loan repayment schedule, interest rate, or penalties – that normally apply to a debt.

During 2010 and 2011 (the years at issue), Taxpayer reported operating losses. However, during the same years, Taxpayer paid \$181,872.09 of Mr. Singer's personal expenses by making payments from its bank account to Mr. Singers' creditors. These payments made on behalf of Mr. Singer were treated on Taxpayer's general ledgers and corporate income tax returns as repayments of shareholder loans. Taxpayer did not report paying any wages to Mr. Singer.

The Internal Revenue Service (Service) issued a Notice of Determination of Worker Classification (NDWC) to Taxpayer for all taxable periods for each of the years at issue. In the NDWCs, the Service determined that Mr. Singer was an employee of Taxpayer and that Taxpayer was not entitled to relief from employment tax pursuant to Section 530 of the Revenue Act of 1978. The NDWCs also determined that a portion of the payments that Taxpayer made to or on behalf of Mr. Singer constituted reasonable compensation for services that were properly subject to Federal employment taxes.²

In its Opinion, the Court stated the issues for decision as (1) whether Mr. Singer, the sole shareholder-officer, should be classified as an employee for employment tax purposes; and (2) whether Taxpayer's payment of personal expenses on behalf of Mr. Singer should be characterized as wages subject to Federal employment taxes.

Regarding the classification of Mr. Singer, the Tax Court held that Mr. Singer was an employee of Taxpayer based on his status as an officer who performed substantial services.³

¹ The Federal employment taxes are the Federal Insurance Contributions Act (FICA) taxes (under I.R.C. §§ 3101-3128), the Federal Unemployment Tax Act (FUTA) taxes (under I.R.C. §§ 3301-3311), and the collection of income tax at source on wages (under I.R.C. §§ 3401-3406).

² The 2010 NDWC set forth a wage amount of \$60,000, which is roughly half of the personal expenses paid by Taxpayer on behalf of Mr. Singer in 2010. The 2011 NDWC set forth a wage amount of \$59,037, which is roughly all of the personal expenses paid by Taxpayer on behalf of Mr. Singer in 2011.

³ The application of Section 530 was not at issue in the case. Taxpayer did not assert that it satisfied the statutory requirements of Section 530 in the pleadings or at trial; and the Court did not discuss Section 530 in the Opinion.

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Regarding the characterization of the payments as wages, the Tax Court focused entirely on whether there was a genuine intention to create a debt with a reasonable expectation of repayment and whether the intention comported with the economic reality of creating a debtor-creditor relationship, rather than applying employment tax principles regarding the scope of wages, and held in favor of the Taxpayer.

The Court concluded that a debtor-creditor relationship was intended with respect to advances between 2006 and 2008 because Taxpayer reported the advances on its general ledger and corporate tax returns as loans, the recurring nature of the payments to satisfy the Singers' home mortgage and personal vehicle loan obligations – regardless of the value of the services Mr. Singer provided – was characteristic of debt repayments, and most importantly, the payments were made despite Taxpayer's operating at a loss. The Court further found that Mr. Singer had a reasonable expectation of repayment for the advances between 2006 and 2008 because the business was operating profitably and showed signs of growth. With respect to the subsequent advances, however, the Court found that Mr. Singer did not have a reasonable expectation of repayment because the business was struggling during those subsequent years. The Court held these later advances to be in the nature of capital contributions. The Court also held that Taxpayer had a sufficient outstanding loan balance at the time the payments were made so that the payments were appropriately characterized as valid loan repayments and should not be characterized as wages subject to employment taxes.

For employment tax purposes, "wages" are defined as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions not applicable to this case. See Internal Revenue Code (Code) sections 3121(a), 3306(b), and 3401(a). See also Treas. Reg. §§ 31.3121(a)-1(b) and 31.3401(a)-1(a)(1), (2). Employment is defined generally as any service, of whatever nature, performed by an employee. See Code section 3121(b). In determining whether a payment made to an employee is wages subject to employment taxes, it is irrelevant how an employer characterizes the payment. See Treas. Reg. §§ 31.3121(a)-1(c); 31.3401(a)-1(a)(2). The form of the payment is also immaterial. See Treas. Reg. §§ 31.3121(a)-1(e); 31.3401(a)-1(a)(4). There is no provision in the Code or regulations that authorizes an employee to waive his or her right to receive wages, and thereby characterize payments that are made to the employee or benefits that are provided to the employee as something other than wages.

The critical factor in determining the appropriate tax treatment is whether the payments are remuneration (i.e., compensation) for services provided to the employer. The Service disagrees with the Court's reasoning, which failed to properly address the critical issue of whether the payments made by Taxpayer to creditors on behalf of Mr. Singer were compensation for his services and thus wages under the applicable statutory and regulatory provisions. The Service's position is that the Court incorrectly decided that no portion of the payment of personal expenses by Taxpayer on behalf of Mr. Singer should be characterized as wages subject to Federal employment taxes. Whether advances made to a corporation by a shareholder-officer are characterized as loans rather than capital contributions does not control whether a payment made by the corporation to the shareholder-officer is compensation for services and therefore properly characterized as wages. The Court failed to acknowledge that, similar to debt repayments, wages are also paid in a recurring nature and may be paid even if a business is operating at a loss.

In focusing on the intention to create a debtor-creditor relationship and whether Mr. Singer had a reasonable expectation of repayment of the advances, the Court failed to analyze or even cite the relevant statutory or regulatory provisions governing the definition of wages for Federal employment tax purposes. Nor did the Court review its own substantial body of case law that repeatedly rejects taxpayers' attempted characterizations of payments to officers who perform substantial services as something other than compensation for services. The Court failed to analyze why precedents concerning officer

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compensation were not applicable. See Veterinary Surgical Consultants PC v. Commissioner, 117 T.C. 141 (2001) (stating that “the characterization of the payment to [president] as a distribution of net income is but a subterfuge for reality;” and holding the payments constituted remuneration for services performed by the [president] and were subject to employment taxes). See also Glass Blocks Unlimited v. Commissioner, T.C. Memo 2013-180 (holding that “[a]n employer cannot avoid Federal employment taxes by characterizing payments to its employee, sole officer and shareholder as something other than wages where such payments represent remuneration for services rendered”). See Smith v. Commissioner, T.C. Memo. 1995-410 (finding that payments of personal living expenses made by a wholly owned corporation on behalf of its president/employee and sole shareholder, who received no salary in the year at issue, are properly characterized as wages when they represent remuneration for employment).

Several circuit courts have also rejected arguments that officers who perform substantial services received something other than compensation for those services. See Joseph M. Grey Accountant, P.C. v. Commissioner, 119 T.C. 121 (2002), aff'd 93 Fed. Appx. 473 (3rd Cir. 2004) (holding that money taken from corporate account by the sole shareholder and president of the corporation to pay for his needs as they arose was wages subject to employment taxes); Joly v. Commissioner, 211 F.3d 1269 (6th Cir. 2000) (holding that distributions to controlling shareholders were wages despite an express written agreement that any excess distributions would be treated as loans); Joseph Radtke S.C. v. United States, 895 F.2d 1196, 1197 (7th Cir. 1990) (holding that dividends paid by the corporation to the only significant employee, who otherwise received no salary for his substantial services, were in fact wages subject to employment taxes because the payments “were clearly remuneration for services performed”); David E. Watson, P.C. v United States, 668 F.3d 1008 (8th Cir. 2012) (holding that the proper legal analysis was whether the payments at issue were made as remuneration for services performed; rejecting the argument that taxpayer intent controls when characterizing payments and finding dividend distributions should properly be characterized as wages, despite repeated assertions by the taxpayer that there is no statute, regulation, or rule requiring an employer to pay minimum compensation); Spicer Accounting, Inc. v. U.S., 918 F.2d 90, 93 (9th Cir. 1990) (holding that the only stockholder of an S corporation, who “donated” his services and withdrew earnings in the form of dividends, actually received wages; stating that regardless of how an employer chooses to characterize payments made to employees, “the true analysis is whether the payments are for remuneration for services rendered”).

While none of the courts in the cases cited above found the existence of a debtor-creditor relationship, the applicable employment tax regulations defining the scope of wages as all remuneration for employment does not cease to apply even if such debtor-creditor relationship is present. As previously noted, the regulations expressly provide that an employer’s characterization of the payment is irrelevant. Accordingly, when a corporation makes any payment of personal expenses to or on behalf of a shareholder-officer, the question must be asked – is the payment being made as remuneration for services? If so, then the payment is wages. While the Service may recognize a payment from a corporation to its shareholder-officer who is also an employee as a loan repayment, the taxpayer must provide objective evidence that both substantiates that a bona fide loan exists between the parties and substantiates that the payment from the taxpayer to the employee was specifically in repayment of that loan and is separate from compensation paid to the employee for the performance of services for the taxpayer.

Accordingly, unless a taxpayer objectively substantiates both the existence of a loan and that payments made were in repayment of that loan, the Service will continue to assert that the payment of personal expenses by an S Corporation on behalf of its corporate officer/employee constitute wages subject to Federal employment taxes.

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Recommendation: Acquiescence in result only.

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