

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

January 7, 2003

Dear . . . :

This responds to your letter dated May 15, 2002, and subsequent correspondence. You have requested a letter ruling to determine whether the Service may recharacterize dividends declared by an S corporation as wages subject to employment taxes. Also, you have requested a determination as to what amounts distributed from an S corporation to a shareholder/manager are reasonable compensation for services provided by the shareholder to the S corporation.

The determination of whether an S corporation distribution constitutes wages or dividends is a factual matter. Pursuant to § 7.01 of Rev. Proc. 2002-1, 2002-1 I.R.B. 1, the Service will not issue a letter ruling in areas involving an issue of a factual nature. In addition, pursuant to § 3.01(15) of Rev. Proc. 2002-3, 2002-1 I.R.B. 117, the Service will not rule on whether compensation is reasonable in amount.

While we are unable to issue a letter ruling, we are furnishing the following general information in response to your request. Section 2.04 of Rev. Proc. 2002-1 provides that an information letter is advisory only and has no binding effect on the Service.

Rev. Rul. 59-221, 1959-1 C.B. 225, holds that amounts of S corporation undistributed taxable income which are required to be included in each shareholder's gross income do not constitute net earnings from self employment to shareholders. Rev. Rul. 59-221 does not address whether amounts paid or distributed to a shareholder of an S corporation are characterized as dividends or as wages to the shareholder.

By contrast, Rev. Rul. 74-44, 1974-1 C.B. 287 addresses the characterization of "dividends" distributed by an S corporation to its shareholder. It holds that "dividends" paid to shareholders will be recharacterized as wages when such "dividends" are paid to shareholders in lieu of reasonable compensation for services performed for the S corporation.

In Veterinary Surgical Consultants, P.C. v. Commissioner, 117 T.C. No. 14 (2001) aff'd without published opinion, No. 02-1214 (3rd Cir. Dec. 18, 2002), the S corporation's sole shareholder and officer provided all services on behalf of the S corporation and generated all of the S corporation's income through services that he provided. The corporation did not pay the shareholder a salary; rather, the corporation distributed its net income to the shareholder, who then reported the payments (as indicated on the Schedules K-1) as nonpassive income from the S corporation. Consequently, the S corporation did not pay any FICA (social security and Medicare) or FUTA (unemployment) taxes under §§ 3111 and 3301 of the Internal Revenue Code. The court stated that §§ 3121(a) and 3306(b) generally define "wages," for federal employment tax purposes, as all remuneration for employment. Pursuant to §§ 31.3121(a)-1(b) and 31.3306(b)-1(b) of the Employment Tax Regulations, the form of the payment is immaterial. Under § 3121(d), the term "employee" includes an officer of a corporation. Section 31.3121(d)-(1)(b) provides an exception for officers who do not provide any services (or provide only minor services) and who neither receive nor are entitled to receive remuneration. The court therefore held that "an officer who performs substantial services for a corporation and who receives remuneration in any form for those services is considered an employee, whose wages are subject to Federal employment taxes." Id. at 7. The court also stated that "an employer cannot avoid Federal employment taxes by characterizing compensation paid to its sole director and shareholder as distributions of the corporation's net income, rather than wages." Id. at 8. Accordingly, the S corporation's payments to the shareholder were recharacterized as wages. See also, Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990).

Generally, under the rules described above, if a shareholder of an S corporation performs services for the corporation, any distribution to the shareholder, even if legally declared under state law by the S corporation as a dividend, will be characterized as "wages" subject to employment taxes where in reality the payments are for services. An S corporation cannot avoid employment taxes merely by paying the corporate shareholder "dividends" in lieu of reasonable compensation for services performed.

We hope that the above information proves helpful in answering your question.

Sincerely,

J. Thomas Hines
Chief, Branch 2
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures: (3)
Copies of cases