



# How to Defend Against EDD's Audits of S Corp. Income

By David M. Fogel, EA, CPA

The California Employment Development Department (EDD) is auditing S corporations and treating dividends, flow-through income and other distributions made to officers-shareholders as wages, resulting in additional California employment taxes. This article suggests ways to defend against such an audit.

## Background

For 2003, California imposes the following employment taxes on compensation paid to employees:

- Unemployment Insurance (UI) (0.9% to 5.4% of the first \$7,000 of compensation),
- State Disability Insurance (SDI) (0.9% of the first \$56,916 of compensation),
- Employment Training Tax (ETT) (0.1% of the first \$7,000 of compensation), and
- Personal Income Tax (PIT) withholding.

About a year ago, EDD embarked on an audit project in which it is targeting S corporations that have a relatively small number of shareholders. EDD auditors are reclassifying all dividends, flow-through income and other distributions made to corporate officers-shareholders as wages, resulting in additional UI, SDI, ETT, PIT, interest, and in some cases, penalties.

One would think that such an audit would not result in much tax given the low tax rates and their respective compensation maximums. Altogether, UI, SDI and ETT owed on the maximum amount of compensation add up to less than \$1,000. However, the PIT withholding can be a significant amount of tax since it has no compensation maximum and EDD usually uses 6.0% as the tax rate.

## What Law is EDD Relying Upon to Support its Audit Adjustments?

EDD is relying upon a variety of code sections, a case and a ruling to support its adjustments.

Under the California Unemployment Insurance Code (CUIC), an officer of a corporation is an employee<sup>1</sup> and wages means all remuneration payable to an employee for personal services<sup>2</sup>. Amounts paid by an employer on behalf of an employee are also wages<sup>3</sup>. In one case, two officers-shareholders of a corporation who withdrew profits and had the corporation pay some of their private bills were held to be employees; employment taxes were owed on the amounts paid to them or on their behalf<sup>4</sup>.

In the case of S corporations, EDD has ruled —

- if corporate officers or shareholders perform no services for the corporation, profits withdrawn from the

corporation (*e.g.*, as dividends) are not wages for purposes of UI, SDI, ETT and PIT;

- if services are performed and profits are withdrawn, amounts treated as wages will be determined; and
- if services are performed and profits are not withdrawn, EDD may apply a “rule of constructive payment” to determine that wages were paid, indicating that EDD may even impose employment taxes on S corporation income that is not distributed to its officers or shareholders<sup>5</sup>.

For each of these situations, EDD said that it will follow Federal law in determining whether amounts paid to corporate officers or shareholders are wages<sup>6</sup>.

## Federal Law — How Much S Corporation Income Should be Treated as Wages?

California's definition of wages is similar to Federal law in that both define wages as remuneration paid for employment<sup>7</sup>.

In a number of recent cases decided under Federal law, if an S corporation has income that flows through to the officer-shareholder or makes distributions of income to the officer-shareholder, and if the S corporation does not treat any portion of such income as wages, then the entire amounts paid will be treated as compensation for services subject to employment taxes<sup>8</sup>.

The Internal Revenue Service has ruled that where an officer or shareholder of an S corporation performs services for the S corporation and arranges to receive entirely dividends and/or flow-through income from the S corporation instead of being paid reasonable compensation, the portion of such distributions that is made in lieu of reasonable compensation for services is to be treated as wages<sup>9</sup>. EDD has specifically adopted this interpretation of the law<sup>10</sup>.

Whether a distribution should be treated as a dividend or as compensation is a matter to be determined in view of all the evidence<sup>11</sup>. If an S corporation has treated a portion of payments made to its officers-shareholders as compensation, and if the portion so treated represents reasonable compensation, then the remaining portion is a dividend, not compensation<sup>12</sup>.

Accordingly, EDD should be able to treat dividends and other distributions as wages *only* to the extent that the total amount paid by the S corporation to the officer-shareholder (including the amount that the S corporation reported as wages) represents *reasonable* compensation. If the S corporation reported a portion of its payments to the officer-shareholder as wages, and if that portion represents the maximum amount of compensation

that is reasonable under the circumstances, then no additional amount may be treated as wages.

## How Do You Determine the Amount of Compensation that is *Reasonable*?

The determination of whether the amount of compensation paid is reasonable is the same determination that is made to test the deductibility of compensation for Federal income tax purposes — whether the payments are reasonable and are in fact purely for services<sup>13</sup>. What constitutes reasonable compensation to a corporate officer-shareholder is a factual question that must be determined in light of all of the evidence<sup>14</sup>.

Factors considered by the courts in making this determination include: (1) the employee's qualifications, (2) the nature, extent and scope of the employee's work, (3) the size and complexities of the business, (4) the prevailing general economic conditions, (5) a comparison of salaries paid with the gross income and the net income of the business, (6) comparison of salaries with distributions to stockholders, (7) the prevailing rates of compensation for comparable positions in comparable concerns, (8) the salary policy of the corporation as to all employees, and (9) in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years<sup>15</sup>.

In *Elliotts, Inc. v. Commissioner*<sup>16</sup>, the Ninth Circuit Court of Appeals classified these factors into five broad categories, and recent cases have followed this analysis<sup>17</sup>:

- the employee's role in the company, including the employee's position, hours worked, and duties performed, plus any special duties or role (such as personally guaranteeing corporate loans);
- a comparison of the compensation paid to the employee with the compensation paid to similarly situated employees in similar companies;
- the character and condition of the company, including the sales, net income, capital value, and general economic fitness of the company;
- whether a potential conflict of interest exists where the company has the ability to disguise dividend payments as deductible compensation, particularly when the employee is the sole or majority shareholder, and/or where a large percentage of the compensation is paid as a "bonus"; and
- whether there is internal consistency in compensation, *i.e.*, whether compensation was paid pursuant to a structured, formal program and consistently applied throughout the ranks of the company.

However, this seems to be a subjective analysis. Is there perhaps an easier way to demonstrate to EDD that the portion the S corporation reported as wages was reasonable compensation?

## What Tools are Available to Determine the Amount of Reasonable Compensation?

As mentioned above, one way to demonstrate that the amount treated as wages was reasonable is to submit data from a compensation survey showing that the amount was within the range of compensation paid to similarly situated employees in similar companies.

There are numerous organizations that maintain data on executive compensation, broken down by the type and size of the company, geographic location and the individual's position with the company. Valuation Resources.com ([www.valuationresources.com/CompensationSurveys.htm](http://www.valuationresources.com/CompensationSurveys.htm)) is a good starting point to locate organizations that maintain such databases or have software available. Two examples of software programs that will calculate a range of maximum reasonable compensation from financial information about the company are the Executive Compensation Assessor™ from the Economic Research Institute ([www.erieri.com](http://www.erieri.com)) and Compdata Surveys from Dolan Technologies Corp. ([www.compdata.com](http://www.compdata.com))<sup>18</sup>.

### EXECUTIVE COMPENSATION RESOURCES

- **Valuation Resources.com**  
([www.valuationresources.com/CompensationSurveys.htm](http://www.valuationresources.com/CompensationSurveys.htm))
- **Executive Compensation Assessor™** ([www.erieri.com](http://www.erieri.com))
- **Compdata Surveys**  
([www.compdata.com](http://www.compdata.com))<sup>18</sup>

search Institute ([www.erieri.com](http://www.erieri.com)) and Compdata Surveys from Dolan Technologies Corp. ([www.compdata.com](http://www.compdata.com))<sup>18</sup>.

## If EDD Still Reclassifies the Amounts as Wages, What Should You Do?

*If a reasonable amount was treated as wages, then you should appeal EDD's adjustments!*

I am aware of two instances where the corporation treated a reasonable amount as wages, and the audit adjustments were subsequently conceded. In one instance, the S corporation paid its president \$570,000 in wages plus \$1.6 million other distributions over a 4-year period. The EDD auditor reclassified the \$1.6 million distributions as wages and sent a bill for more than \$100,000 additional taxes (mostly PIT). The Appeals Board subsequently conceded the adjustments after being provided a compensation survey showing that the amount treated as wages was reasonable. In the other instance, the S corporation paid the officer-shareholder \$180,000 in wages plus \$35,000 in other distributions. The EDD auditor reclassified the \$35,000 distributions as wages and sent a bill for \$10,000 additional taxes (mostly PIT). EDD conceded the case without holding a hearing.

There are several levels of appeal<sup>19</sup>. First, you can request a meeting with the auditor's supervisor and area manager. If you are still unable to resolve the case, you can contact EDD's Taxpayer Rights Advocate (EDD, Tax Branch, MIC 93, Taxpayer Advocate Office, P.O. Box 826880, Sacramento, CA 94280-0001, Tel. 916/654-8957, Fax 916/654-6969). If the problem still is

not resolved, a formal appeal must be made generally within 30 days from the date of EDD's assessment by filing a Petition for Reassessment. Instructions for filing a petition are contained in Form DE 2350 ("Notice of Petition Rights"), which the auditor sends out with the audit report. After filing the petition, the case will be assigned to an administrative law judge of the California Unemployment Insurance Appeals Board who will hear the case.

*If the appeal is unsuccessful, advise the client to obtain employee certifications for relief of the PIT and file other amended tax returns.*

EDD will relieve an employer from the full amount of PIT for any worker who certifies that the wages were reported on his or her California income tax return<sup>20</sup>. The employer should obtain the properly completed form from the workers<sup>21</sup>.

California imposes a tax of 1.5% on the net income of an S corporation<sup>22</sup>. If the S corporation reported net income on its California returns for the years in question, and if EDD treats the dividends, flow-through income and/or other distributions as wages, then the S corporation is entitled to an additional deduction for these additional wages. This will reduce the amount of the S corporation's taxable income subject to the 1.5% tax.

The additional deduction for wages will reduce the amount of ordinary income (or increase the loss) that flowed through to the shareholder. Although amended S corporation returns could be filed to claim this additional deduction, this will not change the shareholder's individual returns because the decrease in S corporation income will be offset by an increase in the shareholder's compensation income. However, to take advantage of an interest-free adjustment<sup>23</sup>, amended Federal employment tax returns should be filed to report the increase in wages subject to Social Security (FICA), Medicare and/or Federal Unemployment taxes.

These additional filings will probably result in a net amount of taxes owed. See the examples shown below.

**Example 1:** The corporation paid \$400,000 to shareholder in each of the years 2000, 2001 and 2002. The corporation did not treat any portion of the payments as wages. EDD reclassifies the additional \$400,000 in each year as wages.

	2000	2001	2002	Total
<b>EDD Taxes:</b>				
UI	\$378.00	\$378.00	\$378.00	\$1,134.00
SDI	301.13	416.94	416.94	1,135.01
ETT	7.00	7.00	7.00	21.00
PIT	24,000.00	24,000.00	24,000.00	72,000.00
PIT Abatement <sup>24</sup>	(24,000.00)	(24,000.00)	(24,000.00)	(72,000.00)
Interest	201.25	235.22	235.22	671.69
<b>Federal Employment Taxes:<sup>25</sup></b>				
FICA	9,448.80	9,969.60	10,527.60	29,946.00
Medicare	11,600.00	11,600.00	11,600.00	34,800.00
FUTA	56.00	56.00	56.00	168.00
<b>S Corporation Income Tax:</b>				
1.5% of \$400,000	(6,000.00)	(6,000.00)	(6,000.00)	(18,000.00)
Interest	(825.97)	(263.88)	(50.51)	(1,140.36)
<b>Totals</b>	<b>\$15,166.21</b>	<b>\$16,398.88</b>	<b>\$17,170.25</b>	<b>\$48,735.34</b>

**Example 2:** The corporation paid \$400,000 to shareholder in each of the years 2000, 2001 and 2002. The corporation treated \$100,000 in each year as wages, the balance as a non-wage distribution. EDD reclassifies the additional \$300,000 in each year as wages.

	2000	2001	2002	Total
<b>EDD Taxes:<sup>26</sup></b>				
UI	\$ -	\$ -	\$ -	\$ -
SDI	-	-	-	-
ETT	-	-	-	-
PIT	18,000.00	18,000.00	18,000.00	54,000.00
PIT Abatement	(18,000.00)	(18,000.00)	(18,000.00)	(54,000.00)
<b>Federal Employment Taxes:<sup>27</sup></b>				
FICA	-	-	-	-
Medicare	8,700.00	8,700.00	8,700.00	26,100.00
FUTA	-	-	-	-
<b>S Corporation Income Tax:</b>				
1.5% of \$300,000	(4,500.00)	(4,500.00)	(4,500.00)	(13,500.00)
Interest	(619.47)	(197.91)	(37.88)	(855.26)
<b>Totals</b>	<b>\$ 3,580.53</b>	<b>\$ 4,002.09</b>	<b>\$ 4,162.12</b>	<b>\$ 11,744.74</b>

## Conclusion

EDD should be able to treat an S corporation's distributions as wages *only* to the extent that the total amount paid to the officer-shareholder represents *reasonable* compensation. If the S corporation treated a portion of its payments as wages, and if that portion represents the maximum amount of compensation that is reasonable under the circumstances, then no additional amount may be classified as wages. Any attempt by the EDD to do otherwise should be appealed, and if the appeal is unsuccessful, the client should be advised to file amended returns with other tax agencies to reflect the increase in wages.

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<sup>1</sup> CUIC sections 621 and 13004.

<sup>2</sup> *Id.*, sections 926, 13004 and 13009.

<sup>3</sup> California Code of Regulations, Title 22, section 4309-1(b)(6).

<sup>4</sup> *Evelyn, Inc. v. California Employment Stabilization Commission*, 48 Cal.2d 588 (1975).

- <sup>5</sup> EDD Legal Ruling 90-2 (June 29, 1990).
- <sup>6</sup> *Id.*
- <sup>7</sup> CUIC section 926 defines “wages” as “all remuneration payable to an employee for personal services...” while Internal Revenue Code section 3121(a) defines “wages” as “all remuneration for employment...”
- <sup>8</sup> *Veterinary Surgical Consultants, P.C. v. Commissioner*, T.C. Memo. 2003-48; *Mike J. Graham Trucking, Inc. v. Commissioner*, T.C. Memo. 2003-49; *Superior Proside, Inc. v. Commissioner*, T.C. Memo. 2003-50; *Specialty Transport & Delivery Services, Inc. v. Commissioner*, T.C. Memo. 2003-51; *Nu-Look Design, Inc. v. Commissioner*, T.C. Memo. 2003-52; *Water-Pure Systems, Inc. v. Commissioner*, T.C. Memo. 2003-53; *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 141 (2001), *affd. in an unpublished opinion by Yeagle Drywall Co. v. Commissioner*, 2003-1 USTC ¶50,141, 54 F.Appx. 100 (3rd Cir. 2003), Cert denied 123 S.Ct. 2623 (2003).
- <sup>9</sup> Revenue Ruling 74-44, 1974-1 C.B. 287.
- <sup>10</sup> EDD Legal Ruling 90-2, *supra*.
- <sup>11</sup> *Joseph Radtke, S.C. v. United States*, 89-2 USTC ¶9466, 712 F.Supp. 143, 145 (E.D. Wis. 1989), *aff’d. per curiam* 90-1 USTC ¶50,113, 895 F.2d 1196 (7th Cir. 1990).
- <sup>12</sup> *Migliore v. Commissioner*, T.C. Memo. 1977-247; Joseph J. Newpol, “Unreasonable Compensation Issue Also Applies to S Corps.,” *Practical Tax Strategies/Taxation for Accountants* (July 1994); Dale W. Spradling, “Are S Corp. Distributions Wages Subject to Withholding?,” 71 *Journal of Taxation* 104 (Aug. 1989); Carol Kulish Harvey and Mary A. McNulty, “Current Developments,” *Business Entities* (WG&L) (Mar./Apr. 1999).
- <sup>13</sup> Internal Revenue Code section 162(a)(1); Treas. Reg. §1.162-7(a).
- <sup>14</sup> *Joseph Radtke, S.C. v. United States*, *supra*; *Pacific Grains, Inc. v. Commissioner*, 68-2 USTC ¶9536, 399 F.2d 603, 605 (9th Cir. 1968); *Owensby & Kritikos, Inc. v. Commissioner*, 87-2 USTC ¶9390, 819 F.2d 1315, 1323 (5th Cir. 1987); *Hoffman Radio Corp. v. Commissioner*, 49-2 USTC ¶9433, 177 F.2d 264 (9th Cir. 1949).
- <sup>15</sup> *Mayson Manufacturing Co. v. Commissioner*, 49-2 USTC ¶9467, 178 F.2d 115, 119 (6th Cir. 1949).
- <sup>16</sup> *Elliotts, Inc. v. Commissioner*, 83-2 USTC ¶9610, 716 F.2d 1241, 1245-48 (9th Cir. 1983).
- <sup>17</sup> See, e.g., *LabelGraphics, Inc. v. Commissioner*, T.C. Memo. 1998-343, *affd.* 2000-2 USTC ¶50,648, 221 F.3d 1091 (9th Cir. 2000); *E.J. Harrison and Sons, Inc. v. Commissioner*, T.C. Memo. 2003-239; *RAPCO, Inc. v. Commissioner*, 96-1 USTC ¶50,297, 85 F.3d 950, 954 (2nd Cir. 1996); *Owensby & Kritikos, Inc. v. Commissioner*, *supra*; *Leonard Pipeline Contractors, Ltd. v. Commissioner*, T.C. Memo. 1996-316.
- <sup>18</sup> These products are listed only to show the availability of software in the marketplace, not as an endorsement.
- <sup>19</sup> See “EDD Goes After S Corp. Shareholder Dividends,” *Spidell’s California Taxletter*, p. 99, 100 (July 2003).
- <sup>20</sup> See EDD Publication DE 231W (Information Sheet, Personal Income Tax Adjustment Process).
- <sup>21</sup> EDD Form DE 938P (Claim for Adjustment or Refund of Personal Income Tax).
- <sup>22</sup> California Revenue and Taxation Code, section 23802.
- <sup>23</sup> See Treas. Reg. §30.6205-1.
- <sup>24</sup> All PIT is abated because the corporation files a properly completed Form DE 938W signed by the shareholder.
- <sup>25</sup> It is assumed that under the provisions of Treas. Reg. §31.6205-1, the additional taxes reported on an amended return will qualify as an interest-free adjustment, and that no withholding tax is due.
- <sup>26</sup> No UI, SDI or ETT taxes because the corporation filed employment tax returns reporting \$100,000 as wages, which exceeds the wage limits for these taxes. All PIT is abated because the corporation files a properly completed Form DE 938W signed by the shareholder.
- <sup>27</sup> No FICA or FUTA tax is owed because the corporation filed employment tax returns reporting \$100,000 as wages, which exceeds the wage limits for these taxes.