

S Corporation Income Subject to Self-Employment Tax

A tax preparer, Mr. Edwards, and his wife, who is a realtor, each owned S corporations in 2002 and 2003. Mr. Edwards ran his tax preparation business through one of the corporations while his wife ran her realtor activity through her corporation. The S corporations recognized the income and operating expenses of their businesses. Neither Mr. Edwards nor his wife received a salary from the S corporations. No payroll taxes were paid on moneys distributed to them. They did report income flowing through to themselves from the S corporations and paid income tax on the amounts, but no FICA or self-employment tax.

A basic principle of taxation is that anyone who earns income should pay tax on it. "The existence of a validly organized and operated corporation does not preclude taxation of income to the service provider instead of the corporation." In this case, the court had to determine whether the S corporations or its shareholders controlled the earning of the income. A corporation earns the income if both of the following are true:

- The person providing the service is an employee of a corporation that has the right to instruct or control the employee in some meaningful sense.
- There exists a contract or similar arrangement between the corporation and the service provider that recognizes the aforementioned right to instruct or control.

Both these factors were absent in this case. Therefore, the court upheld the IRS' decision to subject the taxpayers' income from their S corporations to self-employment tax.

Tax Preparer Tip: If you have S corporation clients where the shareholder(s) are performing services for the S corporation, they should be drawing a reasonable salary and reporting it on Form W-2.

