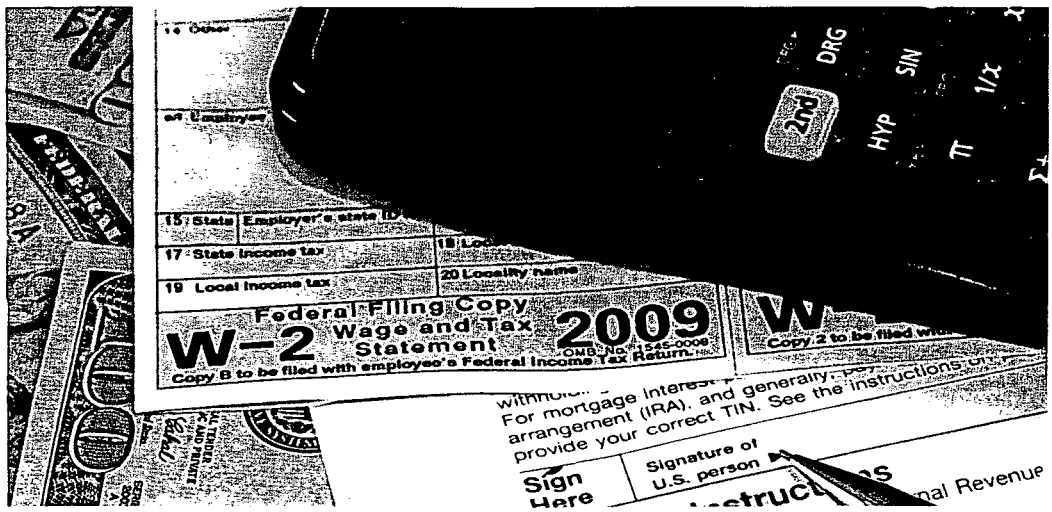
Failing to Issue Form W-2 to Corporate Officers

Small Business/Self-Employed division of IRS issues guidance

By Erik Lammert, J.D.

Most tax preparers are well aware that a corporate officer who performs substantial services for the corporation and receives compensation is considered to be an employee. The corporation should issue a Form W-2 reporting the compensation as wages and withhold proper amounts for federal income tax, FICA, and FUTA purposes.



Recently, the IRS Small Business/Self-Employed Division issued a memorandum providing guidance to IRS agents when a corporation fails to treat an officer as an employee. If the corporation fails to issue a W-2, it may be eligible for relief under one of several avenues.

First, the corporation may be allowed to classify the officer as a non-employee under §530 of the *Revenue Act of 1978* if all of the following conditions are met:

1. The corporation didn't treat the individual as an employee.
2. Federal employment tax returns were filed on a basis consistent with the employer's treatment of the worker as a non-employee.
3. The corporation had a reasonable basis for not treating the individual as an employee. This condition is difficult to overcome because §§3401(c), 3121(d)(1), and 3306(i) for purposes of income tax, FICA, and FUTA withholding, respectively, define an officer of a corporation as an employee for employment tax purposes.
4. The corporation didn't treat any individual in a substantially similar position as an employee.

Secondly, §3509 reduces an employer's liability for income tax withholding and the employee portion of the FICA taxes where the employer unintentionally failed to deduct and withhold those taxes because it treated the employee as a non-employee. That liability is reduced to 1.5 percent of the employee's wages for income tax withholding and 20 percent of the employee's portion of the FICA tax. However, if the employer failed, without reasonable cause, to comply with applicable information reporting requirements consistent with the treatment of the employee as a non-employee, those percentages are doubled. If the employer intentionally disregarded the deduction and withholding requirements, it is liable for the full tax and the lower §3509 rates do not apply.

Example: Abe is an officer of Flybynight Co., an S corporation, for which he performed substantial services and received compensation in 2008. Flybynight treated Abe as an independent contractor, but did not issue him either a Form W-2 or Form 1099-MISC. Instead, Flybynight treated Abe's payments as a distribution and issued him a Schedule K-1. The lower rates of §3509(a) will be used as long as Flybynight did not intentionally disregard the reporting requirements. If no K-1 or other appropriate information return was issued to Abe, still assuming no intentional disregard on the part of Flybynight, the higher §3509(b) rates will be used to compute the tax.

Example: Fastrack Corp. knows that officers who perform services for a corporation are employees by statute. Bernie, an officer of the corporation, performs substantial services, but the corporation deliberately structures his pay as distributions or loan repayment in lieu of a salary or wages. Fastrack Corp. has

intentionally disregarded the rules and regulations and does not qualify for lower §3509 rates.

The memorandum notes that reliance on the preparer is not always reasonable cause. The taxpayer must show he received advice from his counsel, that he relied on it in good faith, and that any such reliance was reasonable.

The §3509 rates do not reduce the employer's liability for the employee's portion of the FICA taxes for statutory employees described in §3121(d)(3) (i.e., certain agent- or commission-drivers, those who sell life insurance full time, home workers, and traveling or city salespersons). If an individual could be classified as either a corporate officer under §3121(d)(1) or a statutory employee under §3121(d)(3), then the §3509 reductions of the employer's liability for the employee's portion of the FICA taxes do not apply. Similarly, if the individual could be classified as either a common law employee under §3121(d)(2) or a statutory employee under §3121(d)(3), then §3509 reductions of the employer's liability for the employee's portion of the FICA taxes would be inapplicable.

To sum up the rule for corporate officers, §3509 reductions apply unless the officer could also be classified as an agent- or commission-driver, a full-time life insurance salesperson, a home worker, or a traveling or city salesperson. If a corporate officer could also be classified as an employee under §3121(d)(3), then the §3509 rates apply only to the employer's liability for income tax withholding and not to the employer's liability for the employee's portion of the FICA taxes.

IRS agents who do not allow the reduced tax rates must develop facts to support their position, and address those facts in their examination report. The IRS cannot issue an assessment for any unpaid employment taxes until after:

1. It has issued a Notice of Determination of Worker Classification (NDWC); and
2. The taxpayer has either exhausted its Tax Court remedies/failed to pursue them, or signed an appropriate waiver of restrictions on assessment. ◤

Memorandum for Employment Tax Territory Managers, Group Managers, and Specialists, July 6, 2009

Paying S Corporation Shareholders' Taxes *By Erik Lammert, J.D.*

An S corporation filed state income tax returns on behalf of its shareholders, and also paid the state income taxes due on their behalf. Originally, the corporation did not have any written or oral agreement with its shareholders to make these payments, but later formalized this practice in a stockholder agreement.

An S corporation must, by definition, have only one class of stock. A corporation may be treated as having more than one class of stock unless all outstanding shares confer identical rights to distribution and liquidation proceeds. Because distributions are based on the number of shares held by each shareholder, distributions should be proportionate to stock ownership.

Worried that the payment of shareholder tax liabilities could inadvertently cause its S election to terminate because the tax payments were deemed to create a second class of stock, the corporation requested a letter ruling allowing it to preserve its S corporation status, and took the following corrective actions, promising it would continue them in future years:

1. It made remedial distributions to correct the effect of the potential disproportionate distributions it may have made; and
2. It began treating state tax payments made on behalf of the shareholders as constructive distributions and took these constructive distributions into account in determining the amount of other distributions and whether all distributions have been proportionate to stock ownership.

The corporation's governing documents provided for identical distributions. The shareholders were unaware that distributions had to be proportionate to stock ownership. After the errors were discovered, distributions were made to even out the original disproportionate distributions.

Based on the above facts, the IRS ruled the corporation will continue to be treated as an S corporation. Neither the original nor the correcting disproportionate distributions result in a second class of stock because the shareholders are entitled to equal distributions under the corporation's governing provisions. ◤

PLR 200934021