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Revenue Ruling 74-44

Section 3121. Definitions

January 1974

Small business corporation dividends paid instead of salaries. Dividends that two sole shareholders of an electing small business corporation arranged to receive instead of reasonable compensation in the same amounts for services they performed constituted "wages" for which the corporation was liable for the taxes imposed by the FICA and the FUTA and the withholding of income tax.

Advice has been requested whether, under the circumstances described below, an electing small business corporation incurred liability for the taxes imposed by the Federal Insurance Contributions Act, Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages (chapters 21, 23, and 24, respectively, subtitle C, Internal Revenue Code of 1954).

The corporation is a small business corporation with two shareholders, that has elected, pursuant to section 1371 (a) of the Code, not to be subject to corporate income tax, but to have all its income taxed directly to its shareholders.

In 1972, the shareholders performed services for the corporation. However, to avoid the payment of Federal employment taxes, they drew no salary from the corporation but arranged for the corporation to pay them "dividends" of 100x dollars, which is the amount they would have otherwise received as reasonable compensation for services performed.

Sections 3121 (a) and 3306 (b) of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, respectively, define the term "wages," with certain specific exceptions not material here, as "all remuneration for employment." Section 3401 (a) of the Code, relating to the withholding of income tax, contains a similar definition.

In the instant case, the "dividends" paid to the shareholders in 1972 were in lieu of reasonable compensation for their services. Accordingly, the 100x dollars paid to each of the shareholders was reasonable compensation for services performed by him, rather than a distribution of the corporation's earnings and profits. Such compensation was "wages" and liability was incurred for the taxes imposed by the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages.