Sadanaga Veterinary Surgical Services, Inc. v. Commissioner, T.C. Memo. 2002-30

An officer of an S corporation who performs substantial services for the corporation and receives remuneration for those services is considered an employee for federal employment tax purposes, regardless of how the payments are characterized.

Summary

Sadanaga Veterinary Surgical Services, Inc., an S corporation wholly owned by Dr. Kenneth Sadanaga, petitioned the Tax Court to dispute the IRS's determination that Dr. Sadanaga was an employee subject to federal employment taxes. Dr. Sadanaga, the president and sole shareholder, provided all consulting and surgical services for the corporation, receiving payments characterized as distributions of net income, not wages. The Tax Court upheld the IRS's determination, finding that Dr. Sadanaga, as a corporate officer performing substantial services and receiving remuneration, was an employee for employment tax purposes. The court rejected the argument that payments were mere distributions of S corporation income, emphasizing that substance over form dictates that compensation for services is wages subject to employment taxes.

Facts

Dr. Sadanaga was the sole shareholder and president of Sadanaga Veterinary Surgical Services, Inc. (SVSS), an S corporation. SVSS's sole business was providing consulting and surgical services, all of which were performed by Dr. Sadanaga for Veterinary Orthopedic Services, Ltd. (Orthopedic). Orthopedic paid SVSS for Dr. Sadanaga's services, reporting these payments as non-employee compensation on Form 1099-MISC. SVSS, in turn, paid Dr. Sadanaga by distributing its net income, which was derived entirely from Dr. Sadanaga's services. Dr. Sadanaga handled all administrative tasks for SVSS and withdrew funds from the corporate bank account at his discretion. SVSS did not issue Dr. Sadanaga a Form W-2 or Form 1099-MISC, nor did it pay federal employment taxes on the amounts paid to him.

Procedural History

The IRS audited SVSS and determined that Dr. Sadanaga was an employee for federal employment tax purposes. SVSS protested, arguing that Dr. Sadanaga was not an employee and that payments to him were distributions of S corporation income. The IRS issued a notice of determination, which SVSS challenged by petitioning the Tax Court.

Issue(s)

1. Whether Dr. Sadanaga, as the president and sole shareholder of Sadanaga Veterinary Surgical Services, Inc., who performed substantial services for the corporation, was an employee of the corporation for purposes of federal

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employment taxes.
2. Whether Sadanaga Veterinary Surgical Services, Inc. had a reasonable basis for not treating Dr. Sadanaga as an employee under Section 530 of the Revenue Act of 1978.

Holding

1. Yes, Dr. Sadanaga was an employee of Sadanaga Veterinary Surgical Services, Inc. for federal employment tax purposes because he was a corporate officer who performed substantial services for the corporation and received remuneration.
2. No, Sadanaga Veterinary Surgical Services, Inc. did not have a reasonable basis for not treating Dr. Sadanaga as an employee because their position was inconsistent with established legal precedent and revenue rulings.

Court's Reasoning

The Tax Court reasoned that under Section 3121(d) of the Internal Revenue Code, officers of a corporation are generally considered employees. The court cited Treasury Regulations stating that an officer who performs substantial services and receives remuneration is an employee for federal employment tax purposes. The court found that Dr. Sadanaga, as president and sole shareholder who worked approximately 33 hours per week providing all of SVSS's services, clearly performed substantial services. The court rejected SVSS's argument that payments were distributions of S corporation net income, stating, "The characterization of the payment to Dr. Sadanaga as a distribution of petitioner's net income is but a subterfuge for reality; the payment constituted remuneration for services performed by Dr. Sadanaga on behalf of petitioner." The court emphasized that the form of payment is immaterial; if it is compensation for services, it constitutes wages. The court distinguished cases cited by SVSS, such as *Durando v. United States* and Revenue Ruling 59-221, noting they pertained to different legal issues (Keogh plan deductions and self-employment income, respectively) and did not support the argument that a sole shareholder officer performing substantial services is not an employee. Regarding Section 530 relief, the court found that SVSS did not have a "reasonable basis" for treating Dr. Sadanaga as a non-employee, as required for safe harbor relief. SVSS's reliance on *Durando* was misplaced, and no other reasonable basis, such as reliance on judicial precedent, published rulings, or industry practice, was demonstrated.

Practical Implications

This case reinforces the principle that S corporation owners who are also officers and actively generate the corporation's income through their services will likely be classified as employees for federal employment tax purposes. It clarifies that labeling payments as "distributions" does not circumvent employment tax obligations when those payments are, in substance, compensation for services

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rendered. Legal practitioners advising closely held businesses, especially S corporations with owner-operators, must ensure that reasonable salaries are paid to shareholder-employees and that appropriate employment taxes are withheld and paid. This case serves as a reminder that the IRS and courts will look beyond the form of payments to their substance when determining employment tax liability and that reliance on misinterpretations of tax law or irrelevant revenue rulings will not provide a “reasonable basis” for avoiding employee classification under Section 530 safe harbor provisions. Subsequent cases and IRS guidance continue to apply this principle, emphasizing the importance of properly classifying shareholder-employees in S corporations to avoid employment tax penalties.

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