

## ***Veterinary Surgical Consultants, P. C. v. Commissioner, 117 T. C. 141 (2001)***

In a significant ruling on S corporation taxation, the U. S. Tax Court determined that Kenneth K. Sadanaga, the sole shareholder and president of Veterinary Surgical Consultants, P. C. , was an employee for federal employment tax purposes. The court rejected the corporation's argument that distributions to Sadanaga were merely pass-through income, not wages. This decision clarifies that officers performing substantial services for an S corporation are employees whose compensation is subject to employment taxes, impacting how S corporations must classify and report payments to shareholder-employees.

### **Parties**

Veterinary Surgical Consultants, P. C. (Petitioner), a Pennsylvania S corporation, filed a petition in the United States Tax Court against the Commissioner of Internal Revenue (Respondent) challenging a Notice of Determination Concerning Worker Classification Under Section 7436.

### **Facts**

Veterinary Surgical Consultants, P. C. was an S corporation incorporated in Pennsylvania on May 22, 1991, with its principal place of business in Malvern, Pennsylvania. The corporation provided consulting and surgical services to veterinarians. Dr. Kenneth K. Sadanaga was the sole shareholder and the president of the corporation, its only officer. During the years in question (1994, 1995, and 1996), Dr. Sadanaga performed all of the corporation's services, working at least 33 hours per week, and was the sole source of the corporation's income. He also had signature authority over the corporation's bank account, handled all correspondence, and performed all administrative tasks. The corporation reported its income on Forms 1120S, and Dr. Sadanaga reported his share of the corporation's income as nonpassive income from an S corporation on his personal tax returns. The corporation did not issue Dr. Sadanaga any Form W-2 or Form 1099-MISC for the years in question, nor did it file any Form 941 or Form 940 for employment taxes. Dr. Sadanaga also worked full-time for Bristol-Myers Squibb Co. and reported wages from them on his personal tax returns.

### **Procedural History**

The Internal Revenue Service (IRS) audited the corporation's 1995 tax return and determined that Dr. Sadanaga was an employee of the corporation for federal employment tax purposes. On November 17, 1998, the IRS issued a Notice of Determination to the corporation, concluding that Dr. Sadanaga was an employee and that the corporation was not entitled to relief under section 530 of the Revenue Act of 1978. The corporation filed a timely petition with the United States Tax Court seeking review of the IRS's determination. The case was submitted to the court fully stipulated, and the court's jurisdiction was expanded to include determining the

correct amounts of federal employment taxes by amendments to section 7436(a) of the Internal Revenue Code. The parties stipulated to the correct amounts of federal employment taxes in the event the court found Dr. Sadanaga to be an employee.

### **Issue(s)**

Whether Kenneth K. Sadanaga, the sole shareholder and president of Veterinary Surgical Consultants, P. C. , was an employee of the corporation for purposes of federal employment taxes during the years 1994, 1995, and 1996?

### **Rule(s) of Law**

Section 3121(d)(1) of the Internal Revenue Code defines an employee, for federal employment tax purposes, as any officer of a corporation. However, an exception exists for an officer who does not perform any services or performs only minor services and who neither receives nor is entitled to receive remuneration, as stated in section 31. 3121(d)-1(b) of the Employment Tax Regulations. Sections 3111 and 3301 impose FICA and FUTA taxes on employers for wages paid to employees, and sections 3121(a) and 3306(b) define “wages” as all remuneration for employment, regardless of the form of payment.

### **Holding**

The Tax Court held that Dr. Sadanaga was an employee of Veterinary Surgical Consultants, P. C. for purposes of federal employment taxes during the years 1994, 1995, and 1996. The court determined that the payments made to Dr. Sadanaga by the corporation constituted wages subject to federal employment taxes, rejecting the corporation’s argument that the payments were merely distributions of net income as an S corporation shareholder under section 1366.

### **Reasoning**

The court’s reasoning was based on the statutory definition of an employee under section 3121(d)(1) and the fact that Dr. Sadanaga was an officer of the corporation who performed substantial services, working at least 33 hours per week. The court rejected the corporation’s argument that the payments to Dr. Sadanaga were distributions of net income under section 1366, noting that section 1366 applies only to income taxes under chapter 1 and not to employment taxes under chapters 21 and 23 of the Internal Revenue Code. The court also considered and rejected the corporation’s reliance on various judicial precedents, revenue rulings, and other arguments as providing a reasonable basis for not treating Dr. Sadanaga as an employee. The court emphasized that the payments to Dr. Sadanaga were remuneration for services rendered and, therefore, constituted wages subject to federal employment taxes. The court also noted that the corporation’s failure to file employment tax returns or issue Dr. Sadanaga a Form W-2 did not change his status as an employee for employment tax purposes.

**Disposition**

The court entered a decision for the Commissioner of Internal Revenue and in accordance with the parties' stipulations as to the amounts of federal employment taxes owed by the corporation.

**Significance/Impact**

This case has significant implications for S corporations and their shareholders who are also officers performing substantial services. It clarifies that such individuals are employees for federal employment tax purposes, and their compensation must be reported as wages subject to employment taxes. The decision impacts how S corporations must classify and report payments to shareholder-employees, potentially increasing the tax burden on such corporations and their shareholders. It also underscores the importance of proper worker classification and the limitations of section 530 relief for S corporations in similar situations. Subsequent cases and IRS guidance have cited this decision in addressing similar issues, reinforcing its role in shaping the legal landscape for S corporation taxation and employment tax obligations.