S Corporations—Audit Triggers

S corporations remain "king of the entities" among those forms of doing business nationwide. Except for the unincorporated sole proprietorships, the S corporation is the most popular form of small business in the United States. In fact, over the past 15 years, the number of S corporations has quadrupled. That trend has not gone unnoticed by the IRS.

Combine the rising popularity of the S corporation with intense pressure put upon the IRS by Congressional leaders to close the "tax gap" (the difference between what is owed and what is collected) and the perfect storm for more IRS audits has developed. A recent report on the tax gap, which hovers at around $300 billion annually, blames up to 80 percent of it on small businesses. IRS intelligence also bears out that result, with a particularly large group of abusive tax techniques concentrated among S corporations.

IRS Commissioner Mark W. Everson reported recently that audits of S corporations have increased over 20 percent during the past year. Everson said that the IRS has begun to place more emphasis on the growing area of flow-through entities, "a source of potential noncompliance." Kevin Brown, the IRS Commissioner of the Small Business/Self-Employed (SB/SE) Division also pulled no punches recently when he commented that "some troublesome areas exist in the area of S corporation tax compliance."

As an S corporation or S corporation owner, we are writing to you to warn you in particular about two new IRS audit initiatives against S corporations. First, the IRS is intensely auditing "a statistical sampling" of S corporations to gather data on what it should look for in auditing other S corporations. Nationwide, this audit blitz now includes 5,000 unlucky S corps. If you are selected, expect a fight on almost every line of your return.

Second, the IRS is attacking S corporation compensation practices. In particular, auditors' eyebrows are being raised if salaries paid by an S corporation to its principal owner or owners look suspiciously low. This "troublesome area," as SB/SE Commissioner Brown calls it, involves a technique in which the S owner/employee draws a low salary to avoid employment taxes that ordinarily would be due on additional wages but would escape tax if passed through as dividends. Brown labeled this practice as "abusive" and warned that "IRS examiners are aware of the practice." Not only are IRS examiners disallowing this technique but they reportedly are also assessing 20 percent accuracy-related penalties. A review of W-2 income and total distributions received by the S corporation owner-employee during the year may be in order for many businesses.

If you would like any further information on the recent IRS audit initiatives against S corporations, or if you would like us to do a thorough review of your compensation practices and other "audit triggers" before the IRS should investigate, please do not hesitate to call our office.