

# Memo

To: *Tax Impact Readers*  
From: Bruce W. Breitweiser  
Date: July 1, 2010  
Re: S Corporations -- Audit Triggers

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S corporations have enjoyed exponential growth over the years, becoming "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. S corporations are estimated to make up roughly 13 percent of all businesses. The growth of S corporations has not gone unnoticed by the IRS.

According to the Government Accountability Office (GAO), the most significant tax reasons for businesses to choose S corporation status include its single level of taxation, ability to pass through business losses to shareholders, and the imposition of employment taxes on wages, rather than net business income. 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.

The IRS received almost 4.4 million S corporation returns for 2008, the year in which the latest data is available. The IRS has begun to place more emphasis on the growing area of flow-through entities, "a source of potential noncompliance." As such, the IRS is currently working on updating its analysis of S corporation collection and compliance data.

Since employment taxes are imposed on all net income of the owners of partnerships and proprietorships, this difference has provided a significant incentive for S corporations to treat wages paid to owners as distributions and has been determined to be a serious area of noncompliance.

The IRS is also looking closely at S corporation compensation practices. In particular, auditors' eyebrows will be raised if salaries paid by an S corporation to its principal owner or owners look suspiciously low. One scenario involves a technique in which the S corporation 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. 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. The IRS has also issued a fact sheet on S corporation compensation.

The ability of S corporations to pass through losses provides a significant advantage over C corporations and is one of the main reasons for business owners to elect S corporation status.

However, a significant area of noncompliance by S corporations that has drawn IRS attention involves incorrect and excessive determinations of basis by S corporations.

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," please call our office.

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Bruce W. Breitweiser  
Managing Partner  
Dunbar, Breitweiser & Company, LLP  
202 North Center Street  
Bloomington, Illinois 61701-3995  
Phone: 309-827-0348 Private line: 309-829-9888 ext. 206  
Cellular: 309-531-1111 Fax: 309-827-7858  
Residence: 309-829-9177 Email: [bbreitweiser@dbc-llp.com](mailto:bbreitweiser@dbc-llp.com)

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