

IRS to Conduct Study of S Corporations

The IRS announced the launch of a new compliance study of S corporations. The study, carried out under the National Research Program (NRP) starts later this year and will examine 5,000 randomly selected S corporation returns from tax years 2003 and 2004. The NRP study will be used to more accurately gauge the extent to which the income, deductions, and credits from S corps are properly reported on returns, including payroll returns, filed by both the corporations and their shareholders.

According to the IRS, the number of S corporations has risen rapidly since the mid-1980s, growing from 724,749 in 1985 to 3,154,377 in 2002. In addition, the IRS notes the growth rate has been even faster among S corporations with more than \$10 million in assets. From 1985 to 2002, the number of these larger S corporations grew more than tenfold, from 2,305 to 26,096.

“The use of S corporations has exploded,” said IRS Commissioner Mark W. Everson. “The IRS needs a better understanding of what this means for tax compliance. This research is critical for achieving our strategic goal of ensuring that corporations and high-income individuals pay their fair share.”

For payroll purposes, the IRS has consistently reminded S corporations that a reasonable compensation must be paid to shareholder-employees in return for their services provided to the company. This must be done before any non-wage distributions are made to shareholder-employees.

Some S corporations are minimizing the salaries of their shareholder-employees and are raising their dividend distributions instead. If successful, this reduces employment taxes at both the corporation and shareholder-employee level because dividend distributions are exempt from FICA taxation.

As a reminder, the IRS in the past has closely monitored compensation paid by S corporations and has challenged low compensation levels. Focus is placed on determining if S corporations are paying a “reasonable salary” to their shareholder-employees, or if they are instead using the taxable distribution from the corporation to compensate the shareholder-employees for services provided. If necessary, the IRS will recharacterize the dividend distributions to shareholder-employees as wages, to provide for reasonable W-2 compensation, for those individuals who actively work in the corporation. As a result, corporations may face applicable employment taxes and deficiency charges, including back taxes, penalties, and interest.