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S CORPORATIONS - NONCOMPLIANCE WITH RULES

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A new Government Accountability Office (GAO) report addresses S corporation noncompliance and makes specific suggestions for correcting the problem. Noncompliance issues include **misreporting of income and or expenses, mistakes in calculating shareholder basis, and failure to pay shareholder employees adequate wage compensation.**

S Corporations Growing In Popularity. The GAO report found that S corporations have been one of the fastest growing business entity types in recent years, doubtless due to limited liability protection to shareholders, and the ability to pass through gains and losses to shareholders' individual tax returns without generally paying taxes at the entity level. According to the most recent IRS data available, the number of S corporations grew by 35% from tax year 2000 to 2006, for a total of nearly 4 million businesses in 2006, and also grew as a proportion of all businesses, from 11.4% of all entities in tax year 2000 to 12.6% in tax year 2006. In 2006, they were the second most common entity type after sole proprietorships. From tax years 2000 to 2006, S corporations' total net income grew by 67%, or \$166 billion, and their total assets grew by 46%, or \$1.0 trillion.

Composition Of S Corporations. GAO found that most S corporations are held by three or fewer shareholders. In tax year 2006, 60% of S corporations had a single shareholder, 89% had two or fewer shareholders, and 94% had three or fewer shareholders.

High Noncompliance Level. According to IRS data, about 68% of S corporation returns filed for tax years 2003 and 2004 (the years data were available) misreported at least one item, and that about 80% of the time, misreporting provided a tax advantage to the corporation and/or shareholder. Besides misreported net income, the most frequently misreported line item was "other deductions," and amount of the line items with the largest misreported amounts were distributions and gross sales. A substantial number of S corporations also deducted personal expenses and did not substantiate deducted expenses. When it analyzed IRS's data, GAO found that the smaller the number of S corporations shareholders, the larger the number of the entity's return errors.

Underreporting Of Shareholder Compensation And Possible Solutions. S corporation shareholders can receive both wages and distributions; but only wages are subject to employment taxes that are to be paid by both the S corporation and those receiving wages. As a result, S corporations that **improperly pay lower shareholder wages** while increasing other payments such as distributions to shareholders, **lower employment tax liabilities.** The GAO report says that about 13% of S corporations paid **inadequate wage compensation**, resulting in just over \$23.6 billion in net underpaid wage compensation to shareholders. What is more, S corporations with the fewest shareholders made up the largest portion of shareholder compensation net underpayments. The median misreporting adjustment for underpaid shareholder compensation in all categories was \$20,000. One of the key causes of underreported compensation, according to IRS officials, was the lack of a clear legal standard and the need to consider various facts and circumstances when determining what is reasonable compensation.

Misreporting Of Basis And Possible Solutions. The GAO report found that one common type of noncompliance occurs when shareholders use S corporation losses beyond their allowable stock and debt basis. Since one advantage of choosing S corporation status is the ability to offset other income with S corporation losses and deductions on the individual income tax return, shareholders who claim losses beyond allowable basis are benefiting improperly. S corporation stakeholder representatives told GAA that calculating and tracking basis was one of the biggest challenges in complying with S corporation rules.

The GAO report says one possible solution to the misreporting of basis would be a legislative change to require the entity to calculate basis and report each shareholder's basis on Schedule K-1. The report also encouraged IRS to send detailed information on the basis rules to newly formed S corporations to alert them and their shareholders to track basis, and to develop a clear "one or two-page guidance sheet for calculating debt basis."

