The IRS watches closely as S corporations snowball

The popularity of S corporations has skyrocketed, with the number of businesses opting for them rising from 725,000 in 1985 to more than 3 million, according to the most recent statistics.

And that growth is well-deserved, S corporations have become such an important business vehicle because taxpayers understand their valuable and flexible value.

Unlike a C corporation, an S corp generally pays no corporate income taxes on its profits. Instead, its shareholders pay income taxes on their proportionate shares, called distributive shares, of the S corp's profits.

Since losses flow through to the shareholders, they can offset income from other sources, and while a partner has to pay self-employment tax on partnership net earnings, the S corp shareholder isn't subject o self-employment tax on their share of income.

That's why S corporation shareholders who are also employees want t keep salaries as lo as possible. That way they can avoid FICA, Medicare, and FUTA taxes. It's easier to write a distribution check than a payroll check with all the related payroll taxes and filing requirements. But it's an absolute red flag to file an S corp return showing taxable income with distributions, but no salaries to the active shareholders. For the C corp, the concern is that salaries are too high, but for S corps, the concern is that salaries are too low or nonexistent.

As S corporation have become more popular as a vehicle for small and midsized businesses, the IRS is stepping up its efforts to ensure that taxpayers don't abuse them.

In 2005, it began a program of 5,000 random audits under the National Research Program from tax years 2003 and 2004. And last year, the IRS audited nearly 14,000 S corporations, up 34% from 2005.

There is a fair amount of abuse in this area, as well as a fair amount of lack of knowledge on how to correctly prepare Sub S returns. People are taking salaries that are too low, sometimes as little as zero, to beat the 15.3% FICA tax. There are those who pay themselves a salary of only $10,000 but take out $90,000 in distributions. This is an area that will bring IRS scrutiny.

There also appear to be a lot of inappropriate deductions in small and midsized S corps – those with gross revenues from $75,000 to $500,000.

There are number of areas on the S corporation return that the IRS will scrutinize. For starters, you have to have a profit motive. You can't just set up a Sub S for personal purposes and take deductions. Some set up the corporation as a sham, but the first thing the IRS will examine at the lower end is whether there is a profit motive.

Next, an S corporation can only have one class of stock. People looking for a preferred economic return or a preference in liquidation are not allowed in the S corporation arena. Sometimes there will be a situation where individual owners decide to take more out of the business, not on a W-2, but as a distribution. That could create a second class of stock and terminate the S corporation. The important exception is that you can have a second class of stock so long as the only distinction is voting rights. But all shares must have the same right in terms of distribution and liquidation proceeds.

If a situation arises where you would like to attract an ineligible shareholder into the corporation, you can have the corporation contribute its assets to a new entity, probably an LLC, and have the investor invest in the LLC.

The accumulated adjustments account is a way of measuring the annual increase of a shareholder's tax basis in the share of the Sub S that he or she or it owns. It's a very critical measurement, because it is a measure of the shareholder’s ability to deduct losses and take tax-free distributions. There are companies that haven’t done this and are faced with a question of deductibility of tax losses or the need to determine the taxability of a particular distribution.

So it’s not unusual to see that a shareholder took a distribution that exceeded their basis, and created dividend income or capital gain income to that shareholder. That’s one of the things the IRS wants to do when they cone in and look. The IRS wants to examine the basis calculations to make sure that the losses are properly deductible and that the distributions are, in fact, tax-free.

The IRS also takes a close look at fringe benefits. This is an area that’s disregarded by a lot of companies, but it gives the IRS a prime opportunity to come in and make adjustments. For example, medical insurance premiums have to adhere to a very strict rule. They’re deductible, but are required to be included in the shareholder’s W-2 income. The shareholder is then allowed a deduction on their individual tax return for the amount of those premiums. It’s the kind of thing an IRS agent will look at and say is not being done properly.

Fringe benefits for a greater than 2% shareholder are limited as to deductibility. Such shareholders are not allowed to participate in a self-insured plan or a cafeteria plan. Mistakes here fall under carelessness, rather than abusiveness, but you can cross over the line pretty quickly.

For S corp shareholders, accrued expenses owed them are deductible only as the related income is recognized by the shareholder, on a cash basis. This is critical area. A shareholder might loan money to the corporation that accrues interest. There’s a potential for abuse. If the taxpayer's S corp was deducing interest expense every year in the year before it's paid to the cash basis shareholder, then they would always get the deduction before the shareholder has to report the income, and the government would always be out of pocket cash for the one year.

Losses are only deductible to the extent of the shareholder's basis in the S corp. Where the shareholder's losses exceed his basis, the shareholder could loan money personally to the business to increase basis and take that pass through loss deduction.

This had been the subject of litigation in recent years, because shareholders don't take care to go through the proper legal steps to secure additional basis. You can't just guarantee the loan that doesn't work. And you can't have a related party loan the money – it must be directly from the shareholder. You can't just make bookkeeping entries – there has to be an actual economic outlay.

The tax advantage of S corp is reflected in the price that they receive upon sale. The target for many private equity groups is middle-market businesses. They want to purchase assets, rather than stocks, by making an election under Section 338(h)(10) of the Internal Revenue Code of 1986, as amended. The advantage to this is that the buyers get to step up the basis of the assets they acquire, claim greater depreciation benefits, lower taxes and greater cash flow.

The effect of the election on the sellers under Code Section 338(h)(10) is that they will be taxed on a deemed asset sale and liquidation, rather than on a stock sale.

It avoids the double tax on appreciation of all the assets, if the sale occurs more than 10 years after the S election. And if the sale occurs within 10 years of the S election, it avoids double tax on appreciation of the assets since the date of the election.