IRS To Examine S Corporation Tax Compliance

The IRS recently announced it plans to randomly audit 5,000 S-corporation tax returns for 2003 and 2004 to study small business tax compliance.

S corporations offer the same liability protection as regular C corporations, but S corporations avoid the double taxation of dividends, because, from a tax standpoint, S-corporation earnings pass through to the individual shareholders' tax returns in proportion to their ownership in the corporation.

For example, if you had one owner of an S corporation (100% ownership) and the S corporation earned $90,000 in operating income, that $90,000 wouldn't be taxed at the corporate level. Rather, it would flow through and be added to the income of the individual owning the S corporation. The earnings would be taxed on the person's 1040 tax return. This would be true if the earnings were retained in the company or paid out as dividends. (Technically, we should think of the *income tax liability* as flowing through to the shareholders. The actual *earnings* could be retained within the company for growth.) There usually isn't any income tax at the corporate level for an S corporation.

One of the goals of the IRS is to determine if S-corporation owners are paying themselves reasonable wages *before* paying dividends. Before paying employment-tax-free dividends, it's expected that officers in an S corporation will first receive an appropriate wage for their services to the corporation.

For example, suppose the owner of an S corporation worked full-time in the company and paid himself $90,000 in dividends, without taking any wages. That's a no-no. The IRS expects to see a reasonable salary before dividends are paid. If the entrepreneur had paid out this money as salary, it would be subject to about $14,000 in employment taxes. Of course, it's not necessary to pay all the $90,000 in salary. It depends upon what's considered reasonable. For example, maybe a salary of $45,000 could be paid and $45,000 taken out as dividends. That would amount to a tax savings of about $7,000. And, that could be fully legitimate.

This is one major reason knowledgeable entrepreneurs use S corporations. They can legally save money on employment taxes. There's no reason to pay *more* than a reasonable salary. Unlike sole proprietorships and limited liability companies (LLCs), earnings retained by an S corporation or earnings paid as dividends aren't subject to employment taxes (Medicare and Social Security Taxes). So, money kept in the company for growth isn't subject to Social Security and Medicare. And, once a reasonable wage is paid, shareholders can receive dividends in proportion to their ownership in the corporation.

Compare the S-corporation situation with a sole proprietorship or a limited liability company (LLC). All $90,000 would be subject to Social Security and Medicare Tax. For one-member LLCs and sole proprietorships, this amounts to about $14,000 paid in extra taxes. This is especially onerous if the money is kept within the company for building the business. (My new book *Getting Rich In Your Underwear: How To Start And Run A Profitable Home-Based Business* discusses sole proprietor taxes in detail.)

Another goal of the IRS is to determine if S-corporation owners are reporting the new health insurance tax deduction properly. Owners of more than 2% of an S corporation are expected to take the health insurance deduction on their personal 1040 tax return and not on the corporation's 1120S informational return.

The health insurance tax deduction confuses some entrepreneurs. In the past, entrepreneurs owning sole proprietorships, LLCs, and S corporations weren't able to deduct health insurance at all. But, then the laws changed and a deduction for health insurance was allowed, which was a good thing. But, for major S-corporation shareholders, the process sometimes seems a bit complex.

The S corporation typically pays health insurance for the major shareholder, who is a corporate officer and thus also an employee of the corporation. Then, like any wages paid to an employee, the corporation takes a deduction for wage expense. But, in the case of the 2% (or more) shareholder, this amount must be reported as wages to the individual. So, it's reported as wage income. But, then on the individual's 1040 tax return there's a line where the amount is entered and it reduces taxable income. The net effect is a deduction for health insurance paid. (This health insurance deduction is reported the same way on the 1040 for sole proprietors and for limited liability company owners.)

The chance of any small business owner having his or her S corporation randomly audited is tiny. About 3 million S-corporation tax returns are filed annually. So, an extra 5,000 audits amounts to a 0.16% audit rate.

Peter Hupalo, author of
How to Start And Run Your Own Corporation: S-Corporations For Small Business Owners