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Highlights

Highlights of GAO-10-195, a report to the Committee on Finance, U.S. Senate

December 2009

TAX GAP

Actions Needed to Address Noncompliance with S Corporation Tax Rules

Why GAO Did This Study

S corporations are one of the fastest growing business types, accounting for nearly 4 million businesses in 2006. However, long-standing problems with S corporation compliance produce revenue losses in individual income taxes and employment taxes. GAO was asked to (1) describe the reasons businesses choose to become S corporations, (2) analyze types of S corporation noncompliance, what IRS has done to address noncompliance, and options to improve compliance, and (3) further analyze the extent of shareholder compensation noncompliance and identify options for improving compliance. GAO analyzed IRS research and examination data; interviewed IRS officials, examiners and other knowledgeable stakeholders; and reviewed relevant literature.

What GAO Recommends

Congress should require S corporations to calculate and report basis for their shareholders' ownership shares.

GAO also recommends that IRS research options for improving the performance of professional tax preparers, provide additional guidance to new S corporations on calculating basis and compensation, require examiners to document analysis of compensation, and provide more guidance on compensation.

In commenting on a draft of this report, IRS generally agreed with our recommendations.

View GAO-10-195 or key components.
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What GAO Found

An S corporation is a federal business type that provides certain tax and other benefits, including a single level of taxation, limited employment taxes, and the ability to pass through business losses to shareholder returns. Single-level taxation can reduce overall taxes assessed based on business income, and applying business losses to individual returns can decrease shareholder tax obligations. S corporations also benefit from limited liability protection.

According to IRS data, about 68 percent of S corporation returns filed for tax years 2003 and 2004 (the years data were available) misreported at least one item. About 80 percent of the time, misreporting provided a tax advantage to the corporation and/or shareholder. The most frequent errors involved deducting ineligible expenses, which could decrease S corporation shareholder tax liabilities. Even though a majority of S corporations used paid preparers, 71 percent of those that did were noncompliant. Stakeholder representatives said that preparer mistakes may be due to the lack of preparer standards as well as their misunderstanding of the tax rules. Shareholders of S corporations also made mistakes in calculating basis – their ownership share of the corporation – when taking losses passed to them from the corporation, potentially decreasing their total taxes. IRS officials as well as stakeholder representatives said that calculating and tracking basis was one of the biggest challenges for shareholders, and that S corporations themselves were in a better position in most cases to calculate basis for their shareholders.

Some S corporations also failed to pay adequate wages to shareholders for their labor for the corporation, which led to underpaying employment taxes. Joint Committee on Taxation (JCT) and Treasury Inspector General for Tax Administration (TIGTA) reports show that inadequate shareholder wage compensation is a significant issue. Using IRS data, GAO calculated that in the 2003 and 2004 tax years, the net shareholder compensation underreporting equaled roughly $23.6 billion, which could result in billions in annual employment tax underpayments. Stakeholder representatives, IRS officials, and TIGTA have indicated that determining adequate shareholder compensation is highly subjective and hinders compliance and enforcement. IRS provides limited guidance on determining adequate compensation. Stakeholder representatives indicated that specific IRS guidance for both new and existing S corporations could help improve compliance. Additionally, IRS examiners often were not taking advantage of certain techniques in examining shareholder compensation. Analyzing a random sample of IRS examinations, GAO found that in cases where IRS examiners did document a form of analysis, they were more likely to make an adjustment than when no evidence of such analysis existed. Currently, IRS does not require specific documentation of their analysis for shareholder compensation by examiners. Legislative options exist to improve compliance with shareholder compensation rules; however, these options also raise notable trade-offs.