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GAO

Report to the Committee on Finance, U.S. Senate

December 2009

TAX GAP

Actions Needed to Address Noncompliance with S Corporation Tax Rules

GAO

Accountability * Integrity * Reliability

GAO-10-195

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Highlights

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

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.
For more information, contact Mike Brostek at (202) 512-9110 or brostekm@gao.gov.

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.

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United States Government Accountability Office
Washington, DC 20548

December 15, 2009

The Honorable Max Baucus
Chairman
The Honorable Charles Grassley
Ranking Member
Committee on Finance
United States Senate

S corporations have been one of the fastest growing business entity types in recent years, displaying the second largest percentage increase among federal business types from tax year 2000 to 2006, next to partnerships.[1] In 2006, nearly 4 million S corporations accounted for $3.3 trillion in total assets as well as $413 billion in total net income.[2] The S corporation entity type provides limited liability protection[3] to shareholders,[4] and S corporations "pass through" gains and losses to shareholders' individual tax returns without generally paying taxes at the entity level.

In addition, if S corporations are not compliant with tax requirements, income, losses, and deductions passed through to the shareholders will be inaccurate, resulting in noncompliance on their individual income taxes. The Internal Revenue Service (IRS) does not have an estimate of tax losses due to S corporation noncompliance. IRS has estimated that income tax revenue losses due to pass-through entities' noncompliance, including S corporations, totaled $22 billion for tax year 2001, which is IRS's most recent estimate. In addition, employment tax revenue losses due to noncompliance with tax rules were estimated to be $15 billion for all types of entities (including S corporations) in 2001. For example, S corporations must pay employment taxes on wage compensation paid to officers and

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[1]This report does not address entities created under state law, such as limited liability companies (LLCs), which may elect to be taxed as S corporations or any of the three other federal business types. Most new partnerships are LLCs.

[2]These figures are based on IRS's Statistics of Income (SOI) data. All SOI dollar figures in this report are converted into 2009 dollars.

[3]Limited liability protection means that a shareholder's financial liability for a company is limited to the amount of their investment in the company. Generally, the shareholder's other personal assets cannot be affected by the company's debts or by any lawsuits.

[4]Owners of S corporations are referred to as shareholders. The percentage of stock (shares) owned by a given shareholder determines his or her ownership stake.

employees. S corporations may be tempted to pay shareholder-employees an inadequate wage and higher distribution[5] to avoid employment tax liabilities.

Due to the growth in S corporations and concerns about its tax losses, you asked us to examine noncompliance with S corporation tax rules. This report (1) describes reasons a business might choose to become an S corporation; (2) analyzes types of S corporation noncompliance, what the IRS has done to address noncompliance overall, and options to improve compliance; and (3) further analyzes the extent of noncompliance involving a long standing concern over inadequate shareholder compensation, and identifies options for improving compliance.

To describe reasons for a business to choose S corporation status, we reviewed relevant literature and interviewed IRS officials. We interviewed over 40 stakeholder representatives of nine industry and professional organizations, including small business associations, tax preparer groups, and legal professionals. Using the information gathered from these sources, we determined tax and nontax considerations that might motivate business owners to elect S corporation status over the other business entity types. To analyze types of S corporation noncompliance, we used data from S Corporation National Research Program (NRP) samples drawn for tax years 2003 as well as for 2004.[6] We also reviewed a random, nongeneralizable sample of 166 cases from the 2003 and 2004 S Corporation NRP for insights on the noncompliance. To determine what IRS has done to address noncompliance and options for improvement, we analyzed IRS examination data from its Examination Operational Automated Database (EOAD) for fiscal years 2006 to 2008. In addition, we interviewed IRS officials, including groups of IRS examiners, and the industry representatives mentioned above, and collected information from IRS on its enforcement and service programs. To further analyze the extent of noncompliance in reporting shareholder compensation, we used data from the S Corporation NRP. To determine options for improving compliance on shareholder compensation, we reviewed relevant studies

[5]A distribution is any payment of S corporation funds to a shareholder, including personal expenses paid by the corporation. A distribution does not include wage payments or repayment of loans.

[6]The NRP studied reporting compliance for a random sample of tax returns filed for tax years 2003 and 2004. IRS examined about 4,800 of these returns to determine whether S corporations accurately reported the income, expenses, and other items.

and articles and interviewed the IRS officials and stakeholder representatives mentioned above. All percentage estimates in this report have 95 percent confidence intervals that are within +/- 8 percentage points of the estimate itself, unless otherwise specified. All other estimates in this have 95 percent confidence intervals that are within +/- 10 percent value of the estimate itself, unless otherwise specified. We determined for the purposes of this review that the data used were reliable. When possible, we compared published results with self-generated analyses. (See app. I for further discussion of our scope and methodology.) We conducted this performance audit from May 2007 to October 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

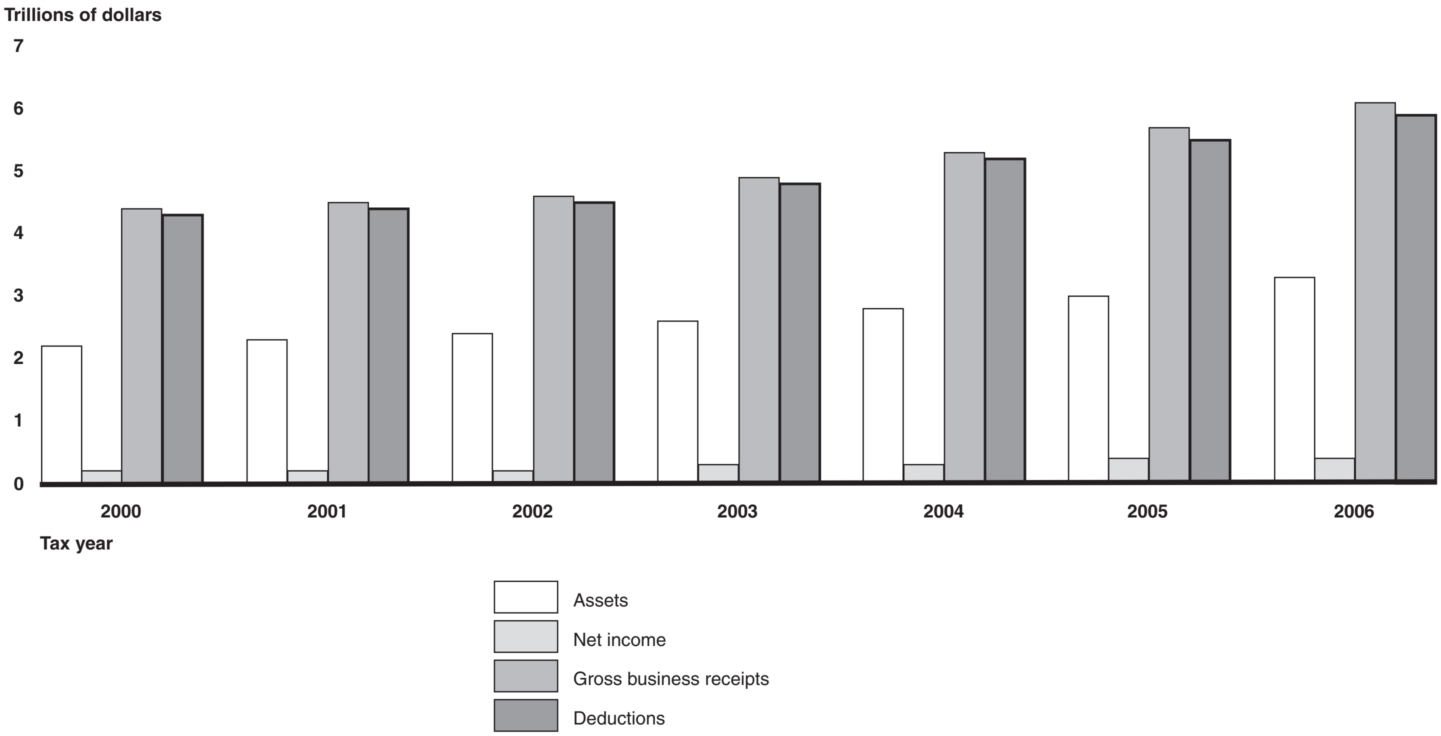
S corporations are a common and growing business type. For federal tax purposes, businesses generally operate as S corporations, C corporations, partnerships, or sole proprietorships. According to the most recent IRS data available, the number of S corporations grew by 35 percent from tax year 2000 to 2006, for a total of nearly 4 million businesses in 2006. S corporations have also grown as a proportion of all businesses, from 11.4 percent of all entities in tax year 2000 to 12.6 percent in tax year 2006. In 2006, they were the second most common entity type after sole proprietorships.

S corporations' assets and total net income also demonstrate their economic significance. From tax years 2000 to 2006, S corporations' total net income[7] grew by 67 percent, or $166 billion, and their total assets grew by 46 percent, or $1.0 trillion.[8] Gross business receipts and deductions also increased substantially in this time period. Figure 1 shows total S corporation assets, net income, gross business receipts, and deductions in tax years 2000 to 2006.

[7]This report uses the "net income (less deficit)" variable for all net income figures, unless otherwise stated.

[8]Adjusted to 2009 dollars. For comparison's sake, net income for all businesses grew by 62 percent and total assets grew by 44 percent over the 2000 to 2006 period.

Figure 1: Total S Corporation Assets, Net Income, Gross Business Receipts, and Deductions, Tax Years 2000 to 2006



Source: GAO analysis of IRS's SOI data.

Most S corporations are held by three or fewer shareholders. In tax year 2006, 60 percent of S corporations had a single shareholder, 89 percent had two or fewer shareholders, and 94 percent had three or fewer shareholders. S corporations held by three or fewer shareholders accounted for the majority of the net income, gross receipts, deductions, and assets for S corporations in 2006, and those held by a single shareholder accounted for over 30 percent of these items.

Conversions of C corporations to S corporations have contributed to the growth in numbers of S corporations; between 78,000 to 97,000 C corporations converted to S corporations per year from tax years 2000 to 2006,[9] representing 23 to 31 percent of new S corporations each year.[10]

[9] Estimates for conversions are within +/-14 percent of the reported values.

Appendix II provides additional details on trends in the growth, size, and characteristics of S corporations.

Reporting Rules

S corporations are small business corporations that file an election form (Form 2553, Election by a Small Business Corporation) that allows them to be taxed under subchapter S of the income tax section of the Internal Revenue Code. They must meet the following requirements to be recognized as an S corporation:

- be a domestic corporation;
- have only eligible shareholders, which include individuals, estates, certain trusts, and certain tax-exempt organizations, but not partnerships, corporations, or nonresident aliens;
- have no more than 100 shareholders (multiple members of a family may count as a single shareholder for this purpose); and
- have only one class of stock.[11]

S corporations file Form 1120S (U.S. Income Tax Return for an S Corporation) to report their business income, losses, and other items related to federal tax laws. S corporations are also required to provide their shareholders and IRS with a Schedule K-1 (Shareholder's Share of Income, Deductions, Credits, Etc.) to report information on the allocation of income, losses, and other items. Using the K-1 information, shareholders of S corporations report their pass-through ordinary income or losses on Part II of Schedule E (Supplemental Income and Loss), which most shareholders are to attach to the individual income tax return, Form 1040.[12] Other separately stated items of income, loss, or deductions are reported on various other Form 1040 schedules. For example, interest income is reported on the shareholder's Form 1040, Schedule B and a capital gain or loss is reported on the shareholder's Form 1040, Schedule D.

Basis

A shareholder can claim S corporation losses and deductions to offset other income earned by the individual shareholder. However, the shareholders generally can only claim losses and deductions up to the

[10] IRS does not have data on conversions from S corporation to C corporation status, but testimonial evidence indicates that this happens infrequently.

[11] 26 U.S.C. § 1361(b).

[12] S corporation shareholders that are not individuals (e.g., trusts and estates) fill out Form 1040 Schedule E, and are to attach it to their respective tax forms (e.g., Form 1041).

amount of basis the shareholder has in the S corporation's stock and debt.[13] Stock basis begins with the shareholder's initial capital contribution to the S corporation or the initial cost of the stock purchased. That amount may increase or decrease each year. An income item will increase stock basis; a loss, deduction or non-dividend distribution will decrease stock basis, based on certain ordering rules. For losses and deductions that exceed a shareholder's stock basis, the shareholder is allowed to deduct the excess up to the shareholder's debt basis, which is created by loans that the shareholder personally made to the S corporation.

Employment Tax

Like any employer, S corporations must pay and withhold for employment taxes on wages.[14] Unlike partnerships and sole proprietorships, S corporations can pay both wages and distributions to shareholders, but only wages are subject to employment taxes. IRS requires that S corporations pay a reasonable compensation (or wage) to shareholders who perform services for the S corporation.[15]

S Corporations Provide Certain Tax-Related and Other Advantages

A single level of taxation, the ability to pass through business losses to shareholders, and calculating employment taxes on wages rather than net business income are the most significant tax-related reasons that business owners elect treatment as an S corporation. While S corporations share each of these characteristics with other business types, it is the only business type with all three of these characteristics, as shown in table 1.

[13]Shareholder claims of losses are also subject to at-risk limitations – they may only claim losses for which they were financially liable – and passive activity rules, which limit claiming losses on business activities in which the shareholder did not materially participate.

[14]Employers are required to withhold for individuals' federal income taxes and Federal Insurance Contribution Act (FICA) taxes, which includes Social Security and Hospital Insurance (Medicare Part A) taxes on employees' wages. They are also required to match the amounts withheld for an employee's Social Security and Medicare taxes, and to pay Federal Unemployment Tax Act (FUTA) taxes on wages paid to employees. Employees' federal income tax withholding, FICA, and FUTA taxes are referred to as employment taxes. The tax rate for Social Security is 12.4 percent of total wages and tips (as well as net earnings for sole proprietorships and partnerships) up to a cap, which was $106,800 for 2009. The tax rate for Medicare is 2.9 percent, with no cap. Federal unemployment tax was 6.2 percent in 2009 on the first $7,000 in earnings. Federal income tax withholding rates vary.

[15]See Rev. Rul. 74-44, 1974-1 C.B. 287.

Table 1: Important Tax Considerations by Business Entity Type

	S corporation	C corporation	Partnership	Sole proprietorship
Levels of taxation	Business income is taxed at the individual tax rate (single level)	Business income is taxed at the corporate tax rate and, if distributed, at the individual dividend tax rate (double taxation)	Business income is taxed at the individual tax rate (single level)	Business income is taxed at the individual tax rate (single level)
Treatment of business losses[a]	Business losses pass through to the individual income tax return and can offset other income	Business losses do not pass through, but can offset business income on the corporate return	Business losses pass through to the individual income tax return and can offset other income	Business losses pass through to the individual income tax return and can offset other income
Employment taxes	Employment taxes are assessed on wages	Employment taxes are assessed on wages	All net income of general partners is subject to self-employment tax	All net income is subject to self-employment tax

Source: GAO analysis.

[a]Various limitations on deducting losses exist for each entity type. S corporation shareholders' abilities to take losses tend to be more limited than owners of partnerships.

S corporation income is generally subject to a single level of taxation, which for many owners means lower total taxes compared to a similarly profitable C corporation. As pass-through entities, S corporations list their net business income and losses on the Form 1120S but are not generally taxed at the entity level; income, losses and deduction items pass through to the individual shareholders' income tax returns, and the individuals are taxed on any net income. Owners of partnerships and sole proprietorships are also taxed only on their business income at the individual level. In contrast, C corporations are subject to double taxation: the corporation is taxed on its net business income, and individual shareholders are also taxed on dividend income received from the business.

Being able to offset income on the individual income tax returns with S corporation losses and deductions can be an important consideration for shareholders who expect and want to obtain tax benefits on those losses and deductions. For some perspective on the possible significance of this advantage, we analyzed loss and gain patterns in 2001 to 2006 for S corporations that took losses in 2003. We found that S corporations that took losses in 2003 tended to take losses in other years as well. Of the S corporations in the SOI corporate sample that took losses in 2003 and filed tax returns in each year from 2001 through 2006, 61 percent took losses in 4 or more of the 6 years. Additionally, 51 percent took losses in 4 or more consecutive years.

To gain perspective on the degree to which shareholders use S corporation losses to offset their other income, we analyzed NRP data on shareholders' 2001 Form 1040s. On average, shareholders using losses from S corporations in 2001 offset an estimated 16.6 percent of their other income with S corporation losses.[16] We estimate that 42 percent of the S corporation shareholders used a loss from an S corporation to offset other income reported on the Form 1040. Many of these shareholders were shareholders of multiple S corporations. Of the shareholders reporting S corporation losses, we estimated that 11 percent reported losses from multiple S corporations, and 29 percent reported income from one or more other S corporations. Appendix III provides analysis on S corporation losses.

S corporation shareholders can also take advantage of losses through business networks; for example, a shareholder of two S corporations can offset income from one S corporation on her individual tax return by taking a loss from the other S corporation. Owners of partnerships and sole proprietorships benefit from taking losses on their individual returns as well. C corporation shareholders, in contrast, cannot directly benefit from their business's losses, since they are taken at the corporate level.

S corporation owners also may prefer the entity's possible lower employment tax burdens compared to partnerships and sole proprietorships. An S corporation pays employment taxes only on wages paid to employees, as do C corporations. For officers and other shareholders who perform services for the corporation, the S corporation is to treat them as employees, determining and paying them an adequate wage, referred to as "reasonable compensation." Shareholders can also receive nonwage distributions that are not subject to employment taxes. By comparison, general partners of partnerships and owners of sole proprietorships generally pay self-employment taxes on the net earnings of the business rather than on wages earned.[17]

[16]For an analysis of loss-taking by sole proprietors, see GAO-09-815, *Tax Gap: Limiting Sole Proprietor Loss Deductions Could Improve Compliance but Would Also Limit Some Legitimate Losses* (Washington, D.C.: Sept. 10, 2009).

[17]With self-employment tax, individuals pay all of the Social Security and Medicare taxes. They get a tax deduction for half of those payments. Limited partners generally do not pay self-employment taxes on income allocated to them by the partnership, except for "guaranteed payments."

Limited Liability Protection and Other Nontax Benefits Are Also Considerations When Choosing S Corporations

As for nontax advantages, limited liability protection was frequently cited by stakeholder representatives we interviewed as a compelling reason for making a business an S corporation. Corporate status provides limited liability protection.[18]

Less influential nontax reasons for choosing an S corporation that were mentioned by stakeholder representatives are corporate image, eligibility for certain government contracts, and the relative simplicity of the business form. Several representatives mentioned that corporations project a more professional image than other entity types, which can be an advantage in getting business. Corporate status is required for eligibility for certain government contracts, making the S corporation a good choice for smaller businesses that want to compete for those contracts. Several stakeholder representatives mentioned the relative simplicity of the S corporation form, in terms of ease of formation, ease of operation, and established case law relative to various other entity types; however, other representatives did not agree that this was a significant reason for choosing the S corporation entity type.

Tax Law Changes May Have Spurred S Corporation Growth

Before 1986, the highest individual tax rate was higher than the highest corporate tax rate; the Tax Reform Act of 1986[19] reversed this for the next seven years (it was reversed again in 1993), expanding the appeal of S corporations, whose shareholders pay their taxes at the individual level. The Small Business Job Protection Act of 1996[20] eased several restrictions on S corporations, including increasing the maximum number of shareholders from 35 to 75 and expanding the type of entities that may be S corporation shareholders. These and numerous other changes by these two laws to the S corporation tax rules enhanced the appeal of S corporation status. S corporations represented less than 6 percent of all businesses in 1986, but their share increased substantially in the years following the passage of these two laws, reaching about 12 percent in 2002.

[18]This reason for choosing S corporation status may be becoming less important with the advent of the limited liability company (LLC). LLCs are entities created under state law that provide similar limited liability protection to a corporation while offering more flexibility in other ways. An LLC may choose to be classified for tax purposes as an S corporation, C corporation, partnership, or sole proprietorship.

[19]Pub. L. No. 99-514, 100 Stat. 2085 (Oct. 22, 1986)

[20] See Pub. L. No. 104-188, 110 Stat. 1755 (Aug. 20, 1996).

The American Jobs Creation Act of 2004[21] further increased the maximum number of shareholders to 100.

In Tax Years 2003 and 2004, a Majority of S Corporations Were Noncompliant with at Least One Tax Rule; Various Options Exist to Address Noncompliance

According to the NRP, an estimated 68 percent[22] of S corporation returns filed for tax years 2003 and 2004[23] misreported at least one item affecting net income.[24] For those years, the overall net misreported amount—accounting for both overreported and underreported amounts—that S corporations passed through to individual shareholders was about $85 billion.[25] For context, assuming that the lowest individual income tax rate of 10 percent applied to this entire misreported amount, $8.5 billion in lost tax revenues for tax years 2003 through 2004 could have been attributable to S corporation noncompliance. However, this represents a highly simplified calculation that is intended solely to illustrate the potential tax impact at the shareholder level from S corporation noncompliance.[26]

S corporations varied in the items that they misreported. Beyond net income,[27] the most frequently misreported line item was "other

[21] Pub. L. No. 108-357, 118 Stat. 1418 (Oct. 22, 2004).

[22]The 68 percent estimate includes misclassification adjustments where a taxpayer reports the correct amount but on the wrong line as well as adjustments where the examiner zeroed out the entire return. For comparison with S corporation misreporting, the NRP for individuals estimated that 70 percent of sole proprietors in tax year 2001 misreported net business income. See *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, GAO-07-1014 (Washington, D.C.: July 13, 2007).

[23]All estimates from the NRP S corporation underreporting study reflect the total over 2 tax years. From the S corporation NRP, 25 percent of the sample came from tax year 2003 and 75 percent from tax year 2004, but both tax years 2003 and 2004 have equal input into our estimates.

[24]We used Form 1120S, Schedule K, line 23 for tax year 2003 and line 17e for tax year 2004 to compute the items affecting S corporation net income that flows through to shareholders.

[25]Estimate is within +/-12.2 percent of the reported value.

[26]This simplified calculation may be too high or too low. A precise estimate would require tracing the S corporation noncompliance through to the shareholder's income tax return to compute the ultimate tax loss. Other factors that could affect the estimate include other income and loss items on the shareholder return, the shareholder's ability to claim any S corporation losses on the shareholder return, and income taxes owed on shareholder's returns from inadequate wage compensation provided to shareholders by S corporations.

[27]Net income is the most frequently misreported and largest misreported line item overall because it is a cumulative line item that is affected any time the items that contribute to it are adjusted.

deductions,"[28] and among the line items with the largest misreported amounts were distributions and gross sales. By median misreported amount, noncompliance was the highest in not paying the correct wage compensation to S corporation shareholders; this noncompliance was much greater than the second highest median misreported amount—distributions to S corporation shareholders. Table 2 identifies the most frequent items that S corporations misreported as well as the amounts misreported (in absolute values).

Table 2: Most Common Misreported Line Items by Number of S Corporations Misreporting and Amounts Misreported (Absolute Dollar Values), Tax Years 2003 and 2004 Combined

Misreported line items	Number misreported (in thousands)	Net misreported amount (in billions)	Median misreported amount
Net income[a]	4,542	$84.8[c]	$5,459[d]
Other deductions[b]	3,532	37.2[c]	4,204[d]
Distributions[i]	1,852	61.8[h]	7,411f
Gross receipts or sales	1,508	25.8[h]	3,988[g]
Cost of goods sold	1,311	—[e]	3,003[g]
Depreciation expense	1,000[c]	5.7[h]	1,755[f]
Shareholder compensation	887[c]	23.6[d]	20,127[d]
Purchases	801[c]	—[e]	2,031[h]
Taxes and license expense	651[c]	1.4[g]	271[h]
Repairs and maintenance expense	585[c]	2.8[g]	1,505[g]
Interest expense	574[c]	2.3[g]	985[h]

Source: GAO analysis of IRS's NRP data.

Note: All data in this table are 2-year data (total over tax years 2003 and 2004). Estimates in the table have a margin of error within +/-10 percent of the reported value unless otherwise specified.

[a]Misreported net income includes both overstated and understated income items and deductions. As a result, some items will increase the net income amount and others will decrease it.

[b]Other deductions include amortization; certain business costs; insurance premiums; legal and professional fees; supplies; travel, meal, and entertainment; and utilities.

[c]Estimate is within +/-16 percent of the reported value.

[d]Estimate is within +/-18 percent of the reported value.

[e]Margin of error was too large to generate a reliable estimate.

[f]Estimate is within +/-30 percent of the reported value.

[28]Other deductions include amortization; certain business costs; insurance premiums; legal and professional fees; supplies; travel, meal, and entertainment; and utilities.

[g]Estimate is within +/-41 percent of the reported value.

[h]Estimate is within +/-89 percent of the reported value.

[i]Distributions do not affect S corporation net income.

The direction of misreporting provided tax advantages for the S corporations or their shareholders. Overall, of noncompliant S corporations, about 80 percent underreported net income by understating income received and/or overstating expenses deducted. For example, as shown in table 3, 88 percent of the misreporting of repairs and maintenance involved overstating these expense deductions, resulting in understated net income. For shareholder compensation, understating rather than overstating the expense deduction provides the tax advantage because lower wage compensation means paying less in employment taxes. Of S corporations that misreported shareholder compensation, 93 percent understated it.[29]

Table 3: Percentage of S Corporations Underreporting and Overreporting Common Line Items, Tax Years 2003 and 2004 Combined

Misreported line items	Percentage understated income	Percentage overstated income
Gross receipts or sales	80	20
	Percentage overstated deductions	**Percentage understated deductions**
Other deductions[a]	91	9
Cost of goods sold	72	28
Depreciation expense	72	28
Shareholder compensation[b]	7	93
Purchases	67	33
Taxes and license expense	70	30
Repairs and maintenance expense	88	12
Interest expense	81	19

Source: GAO analysis of IRS's NRP data.

Notes: All data in this table are 2-year data (total over tax years 2003 and 2004). All estimates in the table have a margin of error within +/-8 percentage points. We excluded the distributions line item because it may not have a tax impact. In general, distributions received by a shareholder are tax-free up to the shareholder's stock basis.

[29]For more information about the extent of noncompliance with shareholder compensation, see pp. 24-36.

[a]Other deductions include amortization; certain business costs; insurance premiums; legal and professional fees; supplies; travel, meal, and entertainment; and utilities.

[b]Understating compensation generally results in underpayment of employment taxes.

Although S corporation shareholders legitimately can offset other income on their individual income tax returns with S corporation losses, some shareholders may be claiming S corporation losses that are not valid. For tax years 2003 and 2004, IRS's NRP examiners raised adjustments to correct the misreported items on the Form 1120S, which caused some S corporations initially reporting a net loss to have net income. As a result, an estimated 13 percent of S corporations claiming net losses changed to net income after examination, compared to 2 percent that changed from net income to losses. We did not have data to trace through how the individual tax liabilities of shareholders would change for those who had used S corporation losses to offset other income when they actually should be adding the S corporation income to their other income on their Form 1040.[30]

Misreporting differed by the number of shareholders, as shown in table 4. For example, a higher percentage of single shareholder S corporations misreported other deductions compared to those with four or more shareholders.

Table 4: Percentage of S Corporations Misreporting Common Line Items by Number of Shareholders, Tax Years 2003 and 2004 Combined

Misreported line item	1 shareholder	2-3 shareholders	4 or more shareholders
Net income	72	63	53
Other deductions[a]	57	48	34
Distributions	30	25	15
Gross receipts or sales	26	18	11
Cost of goods sold	20	20	11
Depreciation expense	16	13	8
Shareholder compensation[b]	15	10	4
Purchases	20	18	11
Taxes and license expense	11	8	6

[30]We reported in 2009 that 70 percent of sole proprietors reporting losses in tax year 2001 had losses that were either partially or fully noncompliant on the basis of NRP examinations. See GAO-09-815.

Misreported line item	1 shareholder	2-3 shareholders	4 or more shareholders
Repairs and maintenance expense	9	9	6
Interest expense	8	9	6

Source: GAO analysis of IRS's NRP data.

Notes: All data in this table is 2-year data (total over tax years 2003 and 2004). All estimates in the table have a margin of error within +/-8 percentage points.

[a]Other deductions include amortization; certain business costs; insurance premiums; legal and professional fees; supplies; travel, meal, and entertainment; and utilities.

[b]Understating compensation generally results in underpayment of employment taxes.

Misreporting varied according to the size of S corporations as measured by assets. For example, a higher percentage of S corporations with assets under $250,000 had at least one adjustment than those with $1 million to $10 million in assets.[31] Those with assets under $250,000 represented 79 percent of all S corporations in the sample.

The S corporation NRP provided an avenue to evaluate noncompliance in misreporting certain line items on the 1120S. As shown in table 5, our review of 166 randomly selected S corporation returns for tax years 2003 and 2004 that IRS examined under NRP identified some types of misreporting.

Table 5: Type of Misreporting by S Corporations, Tax Years 2003 and 2004 Combined

Type of misreporting	Number of S corporations	Number of errors
Deducted personal expenses	69	169
Did not substantiate the deducted expense	52	122
Deducted expense disallowed for other reasons[a]	61	101
Did not claim all allowable expenses	41	64

Source: GAO analysis of 166 randomly selected NRP examinations.

Note: Some S corporations misreported multiple times. For example, an S corporation could have deducted expenses without substantiation more than once throughout the tax return.

[a]Other reasons included deducting an expense paid by an external party, deducting toll violation, and deducting more than allowable gifts.

[31]Adjustments for S corporations with assets over $10 million, the highest asset category, were not significantly different from those in the under $250,000 category. An IRS official noted that the amount of error as a percentage of their income was relatively low.

The most common type of misreporting was improperly deducting personal expenses as business expenses. Of the 166 examination files reviewed, we found 69 returns that erroneously deducted one or more personal expenses, resulting in 169 total errors.[32] These improper deductions included payments for personal taxes, personal tax preparation, personal insurance, personal vehicles, and other personal expenses. Automobile, insurance, telephone, and travel expenses were the most commonly misreported personal expenses; for example, we saw cases in which taxpayers improperly claimed a personal car insurance expense deduction on the Form 1120S.

The second most common type of misreporting on S corporation tax returns we reviewed was not adequately substantiating the expenses. According to stakeholder representatives in the S corporation industry, S corporations may have neither good bookkeeping nor tax professionals that advised them about the importance of bookkeeping under complex S corporation tax rules. These representatives also said that new S corporations may not have consulted a tax specialist when deciding to elect S corporation status, and may not be educated about S corporation tax filing requirements. Another representative told us that some taxpayers may not be doing bookkeeping for tax purposes until they file the 1120S, at which time it becomes a challenge for a preparer to sort out the records and help taxpayers file their return.

S corporations may need a preparer to help them navigate the complex tax rules to remain in compliance. However, paid preparers make mistakes too. IRS's NRP results for 2003 to 2004 showed that 81 percent of the S corporations used a paid preparer. Differences in estimated noncompliance were not statistically significant comparing whether or not a paid preparer was involved in preparing the Forms 1120S. We estimated that 75 percent of the S corporations that did not use a paid preparer were noncompliant while 71 percent of those that used a paid preparer were noncompliant.

To some degree, preparers may contribute directly to S corporation noncompliance. IRS examiners sometimes added notes to the NRP examination files that attributed the noncompliance to mistakes by preparers. For example, in the NRP examination files we reviewed, we found notes that attributed 21 misreported items in 14 files directly to

[32]Some S corporations also had multiple types of misreporting for one line item.

mistakes by preparers. We do not know to what extent preparers contributed to the noncompliance in the other NRP cases absent some indication from IRS's examiners in the case files. On one hand, stakeholder representatives told us that some preparers may innocently make mistakes because the S corporation does not provide them with full and accurate information and records when preparing the Form 1120S. On the other hand, representatives said that some preparers may not be sufficiently trained to prepare S corporation returns. Also, the preparer for the S corporation and individual shareholder returns may be different. IRS officials said that when the preparer for the S corporation differs from that used by the shareholders, it may be challenging to resolve issues that carry across from the entity to the shareholder.

Properly Calculating Basis Is a Challenge for S Corporation Shareholders

In addition to S corporation noncompliance, their shareholders may make errors related to the S corporation. One type of noncompliance occurs when a shareholder uses the 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 us that calculating and tracking basis was one of the biggest challenges in complying with S corporation rules.

To gain further perspective on incorrect basis reporting, we analyzed IRS's annual examinations of individual tax returns that closed for fiscal years 2006 through 2008. In those examinations, the amount of the misreported losses that exceeded basis limitations was over $10 million, or about $21,600 per taxpayer. According to IRS examination officials, lack of basis is one of the largest issues for an S corporation shareholder's tax return, and they noted that these misreported amounts understate shareholder noncompliance because IRS examiners are not fully recording codes in the examination database to identify basis misreporting.

The S corporation NRP examinations could detect an indication of noncompliance with basis issues through the Form 1120S but IRS would need to audit the Form 1040 to verify that noncompliance. As such, shareholder noncompliance was not fully measured because not all shareholders from the S corporation NRP were examined. If a shareholder owned a 20 percent or more interest in an S corporation reporting a net loss, the examiner was required to consider three loss limitation rules—basis, at-risk, and passive activity.[33] Even though estimates are not available, IRS officials said that the NRP showed that some shareholders did not properly track and report their basis, and as a result, improperly used S corporation losses to offset other income on their individual tax returns.

Shareholders are responsible for calculating and tracking basis. While the Schedule K-1 sent to shareholders lists some information that can be used to calculate basis, S corporations are not required to report any basis calculations to shareholders. The only information on how to calculate stock basis is on the Schedule K-1 instructions. Specifically, a voluntary IRS worksheet in the K-1 instructions can be used to calculate stock basis. However, some industry representatives said they do not use the worksheet but instead have come to rely on computer software, which they said is adequate to calculate stock and debt basis at the entity level, and in some cases, provide that calculation to its shareholders.

IRS Addresses S Corporation Tax Noncompliance in Enforcement and Service Programs

IRS enforces compliance with S corporation rules through document matching and examination programs. The Automated Underreporter Program (AUR) matches individual tax returns with information return documents and assesses taxes on those with significant enough discrepancies. For S corporations, AUR matches pass-through income reported on the Schedule E of a Form 1040 to the Schedule K-1. For tax year 2006, AUR assessed over $49 million on just almost 5,200 taxpayers with this mismatch issue, though this number also includes partnerships as well as S corporations. The issue ranked 14th out of 56 different AUR categories in terms of dollars assessed.

Examinations are used to check reporting compliance on tax returns, but due to limited resources, IRS examines only a small portion of S corporations. In fiscal year 2008, IRS examined over 16,000 S corporation returns, which equates to less than 0.5 percent of all S corporations filing tax returns. Of those examined, the items most commonly examined were gross receipts or sales, purchases, shareholder compensation, and other

[33]For example, the shareholder may not have had enough stock and or debt basis to claim a loss from the S corporation or even if they had basis, the at-risk rules may limit loss claims. At-risk rules look to the source of funds. Passive activity losses are limited to passive income. Passive activities are trade or business activities where the shareholder does not materially participate during the year.

deductions. Due to data reliability concerns, we were not able to analyze IRS's examination results for S corporations, such as how often IRS found misreporting and the amount misreported.[34]

One way that examiners detect S corporation noncompliance is IRS's yK1 software program, which uses Schedule K-1 information to graphically depict relationships among taxpaying entities. It displays the shareholders of S corporations as well as any other businesses that are linked to the S corporation, including parent companies and subsidiaries that have common shareholders with the S corporation. Starting with a business entity or individual shareholder, yK1 can show its connections in sending or receiving Schedule K-1s. It shows common use of paid preparers, some family relationships (e.g., husband/wife), and common addresses, among other linkages. For example, if IRS discovers noncompliance that is related to a scheme marketed by a preparer, IRS can use yK1 to identify other entities that used the same preparer. In addition to K-1 data, IRS pulls data from various IRS databases, such as those showing data from filed returns or from information returns filed by third parties. Although there have been no formal analyses of yK1's effectiveness, IRS officials say that its examiners report that using yK1 has helped to identify millions of dollars in unpaid taxes from entities, including S corporations. For S corporations, yK1 data can help examiners determine if the shareholder has stock or debt basis, as well as establish trends in officer's compensation.

IRS aims to educate taxpayers about S corporation rules through its service activities. IRS does not have a publication specific to S corporations but publishes detailed instructions to Forms 1120S and Schedule K-1. IRS also has a toll-free telephone number through which it routes callers to a specialist who can answer questions about S corporations. IRS's Web site has a page that provides information on S corporation filing requirements, with links to other pages on basis, compensation, and shareholders. Finally, IRS sends a letter to newly elected S corporations, alerting these entities that S corporations generally have to pay adequate compensation and that they should contact IRS or go to www.irs.gov for more information. The letter does not communicate

[34]EOAD had multiple entries of misreporting for a line item and we could not reliably determine whether the examiner made a correction at all, much less upward or downward, to the line item. IRS officials could not tell us why this occurred or how to resolve these multiple entries. This problem did not exist with the examination data from the 1120S NRP.

basis requirements or direct taxpayers to specific IRS Web sites related to S corporations.

Options Could Help Further Address S Corporation Noncompliance

As table 6 shows, we developed options for improving compliance with S corporation rules based on interviews with S corporation industry representatives and IRS officials.

Table 6: Options for Improving Compliance with S Corporation Rules

Challenge	Options
Preparer mistakes	Investigate ways to improve performance of practitioners preparing S corporation returns, such as licensing, education, or penalties
Calculating basis	Legislative change to require basis calculation at entity level
	IRS mailing information on basis calculation to new S corporations
	IRS issuing clear, concise guidance for calculating debt basis

Source: GAO analysis.

Option to Address Preparer Mistakes

IRS could improve compliance by investigating options to reduce preparer errors and preparer complicity with noncompliance. Ways to do this include licensing, education, and preparer penalties.

The accuracy of S corporation returns might be improved through the regulation of paid preparers, such as legislation that requires preparers who work on S corporation returns to be licensed. We reported in 2008[35] that federal individual tax returns filed by taxpayers in Oregon, which has a rigorous preparer licensing requirement, were more likely to be accurate compared to those filed by taxpayers in the rest of the country. Preparers in Oregon have to pass an open book examination to receive their licenses to practice, and about 68 percent of the people taking the examination passed. While the people who did not pass cannot legally prepare tax returns in Oregon, paid preparers with an equivalent lack of demonstrated ability may well be working as paid preparers in other states. Further, the IRS Commissioner announced in June 2009 that he will propose a comprehensive set of recommendations to help IRS better leverage the tax

[35] GAO, *Tax Preparers: Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation*, GAO-08-781 (Washington, D.C.: Aug. 15, 2008).

return preparer community with the twin goals of increasing taxpayer compliance and ensuring high ethical standards of tax preparers.

Variations on this option could be to require a special certification specific to S corporations, or a certification that covers all business returns. One tax preparation stakeholder representative said that he has seen preparers who primarily work on individual income tax returns prepare an occasional Form 1120S return; such preparers may not be sufficiently knowledgeable about S corporations, which can lead to mistakes. Instituting preparer licensing requirements would increase the likelihood that a preparer is qualified to prepare an S corporation tax return. One representative said that if he cannot adequately prepare a return, he will refer a client to another preparer, but he believes that many preparers would prepare the return anyway because they want the income. Another representative said that instructions to Form 1120S should state that S corporation taxation is a complex area of the law and is different from individual tax law, and should suggest that the taxpayer seek guidance from a reputable tax consultant in tax return preparation. As IRS develops preparer standards, ensuring that S corporation preparers abide by different rules than individual preparers would acknowledge the vast differences in tax law between these two groups and potentially improve preparer performance for its taxpayers.

Penalties levied on preparers who make mistakes on tax returns are an important tool in improving compliance. Similar to preparers of individual tax returns, penalties can be asserted for S corporation preparers when the tax return they prepared understates tax liability.[36] However, one set of stakeholder representatives cautioned that the penalties for preparer mistakes may not be helping boost compliance with S corporation rules. Examiners are limited in asserting penalties on S corporation preparers because the penalties are based on the tax liabilities, which is not assessed at the entity level but is passed through to shareholders. Thus, the penalty for substantial understatement of tax liability generally would not be assessed against the preparer of an inaccurate Form 1120S return. According to IRS officials, only when an examiner identifies a preparer mistake through a shareholder return, such as for basis or passive activity loss, would an examiner assess the preparer for penalties. IRS agreed to act on our June 2009 recommendation to evaluate penalty administration and penalties' effect on voluntary compliance by developing a plan to

[36]26 U.S.C. § 6694.

collect and analyze penalty-related data.[37] IRS does not have data to show how often penalties are levied on preparers for S corporations compared to individuals or other business. Because IRS does not collect these data by entity type, its ability to evaluate the penalties related to Form 1120S preparers is impeded.

Options to Improve Calculation of Basis

One option for improving compliance with basis rules is for Congress to require S corporations to calculate basis and report each shareholder's basis on Schedule K-1. This could improve compliance to the extent that record-keeping and expertise in basis calculations are better at the entity level than the shareholder level. IRS officials said that during examinations some shareholders are not aware of the basis calculation requirement. This option would most likely help bring some S corporations into compliance by requiring that the calculation be explicitly reported to both shareholders and IRS. In addition, it likely would be most useful for S corporations with multiple shareholders since, for instance, the business and the shareholder are the same in single-shareholder S corporations. Some larger S corporations already report basis information to their shareholders, according to a stakeholder representative.

The least burdensome way for S corporations to calculate basis for their shareholders would be to limit the required calculation to information already possessed by the S corporations; the shareholder would be required to know about and track the information missing from S corporations' calculations. The other way would be to require S corporations to obtain as much missing information from each shareholder as possible in order to more fully calculate stock and debt basis. This would be more burdensome on S corporations but would be more helpful to shareholders, especially if shareholders are less likely than S corporations to know what information is needed. Because some S corporations' tax return programs already compute shareholders' stock and debt basis, the additional burden is minimized. This requirement is similar to that which will require brokers to track basis on investments for their clients.[38]

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[37] GAO, *Tax Administration: IRS Should Evaluate Penalties and Develop a Plan to Focus Its Efforts*, GAO-09-567 (Washington, D.C.: June 5, 2009).

[38] See section 403 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (Oct. 3, 2008); GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance If Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006).

Such missing information at the S corporation level could include a shareholder's initial cost to buy stock from another shareholder, and the value of stock on the date of death for inheritances. According to IRS officials and an S corporation stakeholder representative, information on stock resale can be readily attained by the entity. Currently, shareholders must inform an S corporation of the date and amount of shares transferred to update ownership information and enable the S corporation to properly allocate income and losses between shareholders. It may not be a significant extra burden to require shareholders to also report the cost of the stock to the corporation at the time of acquisition. IRS officials told us that it is not common for only shareholders to possess such basis-related information. However, some industry representatives cautioned that requirements like these would create work for S corporations, and that information on the cost of stock sold or inherited should not be provided to S corporations in order to preserve shareholder privacy.

In addition, partnerships are required to report a similar calculation on their Schedule K-1s to their partners. Partnerships are to report capital account[39] and liability information that can be used as an approximate calculation for basis.[40] S corporations' shareholders do not have a capital account, although the Schedule K-1 does require the entities to report items affecting basis. Stakeholder representatives told us that having similar reporting for S corporations as with partnerships would make sense and improve compliance.

A second option to increase compliance with basis rules is for IRS to send information on basis calculations to newly elected S corporations. Rules could be distributed by U.S. mail, e-mail, or both. While some industry representatives told us that they thought most new S corporation owners would not understand how to track basis and would not pay attention to IRS information about basis, other representatives told us that it would at least alert these new S corporation owners that they have to keep track of something, even if they don't know how to track it. The owners might then hire an accountant who would keep track of basis. Information sent to

[39]A capital account reflects each partner's equity in the partnership, including each partner's capital contribution and profits.

[40]While not designed for the purposes of calculating basis, many industry representatives told us that they can use the partnership K-1s to track basis. The partnership K-1 includes checkboxes for the capital account information, of which tax basis is one option. According to IRS officials, even checking the other options would provide a rough approximation for partnership basis.

newly elected S corporations could also provide specific guidance on appropriate record keeping.

Another option to aid taxpayers in computing shareholder basis is for IRS to publish a clear, one or two-page guidance sheet for calculating debt basis. We developed this option based on input from some industry representatives that additional guidance on basis would improve compliance as well as from IRS officials who indicated the need for such a worksheet. According to IRS officials, determining valid debt basis is a major challenge in calculating shareholder basis. The only IRS information for shareholders on calculating their basis is an IRS worksheet in the K-1 instructions on calculating stock basis. A similar worksheet for calculating debt basis might aid taxpayers and preparers in correctly calculating their full basis but its impact may be limited. Some industry representatives told us that they do not use this stock basis worksheet as tax preparers for S corporations generally use professional tax software to calculate basis at the entity level, and provide the results to the corporation's shareholders. Thus, it is difficult to know whether a similar worksheet on debt basis would increase compliance directly or indirectly. Further, the complexity of issues involved in calculating debt basis would not easily lend itself to a simplified worksheet. IRS officials who tried to develop a concise debt basis worksheet said that too many variables confounded their effort.

However, guidance is among the least costly ways to improve taxpayer compliance, so this option could be cost-effective even if only a small percentage of taxpayers made use of the guidance. IRS officials stated that such impacts would be enhanced if the law was simplified to make debt basis part of stock basis; doing so would decrease the complexities and help taxpayers comply with basis rules, but also would materially change the essence of the current S corporation law.

Inadequate Wage Compensation to S Corporation Shareholders Creates Employment Tax Noncompliance, Which Could be Addressed through Legislative or Administrative Changes

Unlike other types of business entities, S corporations have a possible avenue, whether used unintentionally or intentionally, to avoid employment taxes on payments made to shareholders. 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. [41] As a result, S corporations that improperly pay lower shareholder wages while increasing other payments such as distributions to shareholders, lower employment tax liabilities.

S corporation shareholders who provide labor as employees of the S corporation are subject to employment taxes on their reasonable compensation. Generally, an officer of an S corporation is considered to be an employee of the corporation for federal employment tax purposes,[42] and thus employment taxes must be paid on an estimate of "reasonable" or adequate shareholder wage compensation.[43] However, the difficulty and subjectivity in determining what constitutes an adequate wage enables some S corporations to pay inadequate wage compensation for the labor provided and compensate their officers through higher amounts of distributions, payments of personal expenses, and/or loans.

Compared to S corporations, other entity types operate under different employment tax rules.[44] For example, partnerships and sole proprietorships are not subject to the same employment tax liabilities as are S corporations. Specifically, general partners and sole proprietors are not employees for which employment taxes are to be paid based on wages. Instead, they are considered to be self-employed and must pay self-employment tax on all net earnings derived by the entity.[45] Therefore, the

[41] 26 U.S.C. §§ 3121(a) (FICA), 3306(b) (FUTA).

[42] 26 U.S.C. § 3121(d); Rev. Rul. 73-361, 1973-2 C.B. 331. However, an officer of a corporation who does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is considered not to be an employee of the corporation. 26 C.F.R. § 31.3121(d)-1(b).

[43] IRS will recharacterize distributions provided in lieu of an adequate compensation for services performed by shareholders as wages for employment tax purposes. Rev. Rul. 74-44, 1974-1 C.B. 287.

[44] Regardless of entity type, employers are required to withhold from the wages of all employees, including corporate officers and others who are paid to perform services, amounts for income tax liability and employment taxes, and provide a matching share of employment taxes.

[45] 26 U.S.C. § 1401; 26 C.F.R. § 1.1401-4(c).

partner or sole proprietor is not able to take an inadequate wage to improperly reduce their employment tax liabilities.

Some S Corporations Pay Inadequate Shareholder Compensation and Avoid Employment Taxes

According to NRP data for tax years 2003 and 2004, about 13 percent of S corporations paid inadequate wage compensation, resulting in just over $23.6 billion in net underpaid wage compensation to shareholders.[46] To illustrate the potential impact on employment tax revenue loss from paying inadequate wages, we applied the maximum Federal Insurance Contributions Act (FICA) tax rate of 15.3 percent to the net underpayment amount to compute a simplified calculation of around $3 billion in employment tax revenue losses over tax years 2003 and 2004. Being just for illustrative purposes, this simplified calculation could be too high or too low because it did not attempt to account for all factors that affect employment taxes. For example, all income above the FICA maximum ($106,800 in 2009) is taxed at a lower 2.9 percent rate, which would lower the tax figure.[47] The net effect could be understated because we excluded the 6.2 percent federal unemployment tax due on the first $7,000 in wages. Further, because NRP cannot detect all noncompliance, net effects could be understated.[48]

S corporations with the fewest shareholders made up the largest portion of shareholder compensation net underpayments. For example, single shareholder S corporations accounted for most of the net underpayments and those with one to three shareholders accounted for almost all of the net underpayment as shown in figure 2.[49] The median misreporting adjustment for underpaid shareholder compensation in all categories was $20,127.[50]

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[46]For the 2-year total, the net $23.6 billion accounts for $24.6 billion in understated wages and $1 billion in overstated wages.

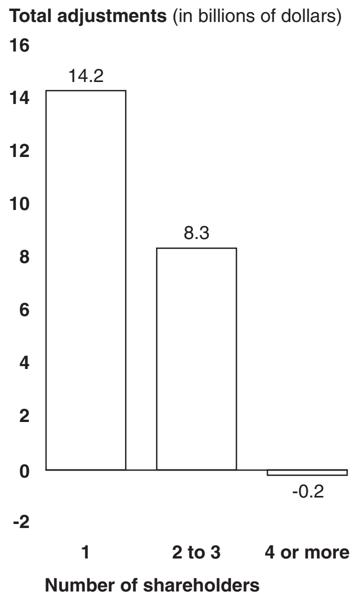
[47]Wages beyond the FICA maximum are subject to taxes for Medicare.

[48]Along with these constraints, this estimate could be high or low due to other taxpayer filing errors that could increase or offset net tax losses and could not be identified in our analysis. For example, though very infrequent, taxpayers may have reported shareholder compensation on the wrong line, which could distort underpayment estimates.

[49]The estimates for each shareholder number group in Figure 2 will not sum to $23.6 billion because $1.2 billion in adjustments were associated with S corporations without a shareholder count. The negative figure for the 4 or more shareholder group means that IRS examiners determined that as a whole, this group was overpaid wages.

[50]Estimate is within +/-17.4 percent of the reported value.

Figure 2: Net Value of Adjustments for Shareholder Compensation in Billions, by Number of Shareholders, Tax Years 2003 and 2004 Combined



Source: GAO analysis of IRS's 2003 and 2004 S Corporation NRP data.

Current Law Does Not Facilitate Consistent Taxpayer Compliance for Adequate Shareholder Compensation

The vagueness of federal tax law on determining adequate wage compensation for shareholders means that the facts and circumstances have to be analyzed in each case. Doing so increases the burden for S corporations to determine adequate compensation and creates opportunities for avoiding employment taxes by paying inadequate compensation. A 2005 TIGTA report found that determining adequate compensation was complex and subjective.[51]

Neither the Internal Revenue Code nor Treasury Regulations have specific guidelines for determining reasonable compensation. However, the determination of reasonable compensation has been extensively litigated, and courts generally evaluate the facts and circumstances of the case to decide whether the wages paid were adequate for the service performed. In examining reasonableness, the courts apply various judicially developed

[51]Treasury Inspector General for Tax Administration, *Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations*, Reference no. 2005-30-080 (Washington, D.C.: May 20, 2005).

factors, although no single factor is considered determinative or more universally important.

According to IRS examination officials, the lack of a clear legal standard and the need to consider various facts and circumstances has made it difficult for IRS to develop comprehensive guidance on what constitutes an adequate wage amount. Instead IRS's only guidance for taxpayers is a list of nine factors provided on August 2008 that various courts have generally considered in determining adequate compensation on the basis of the facts and circumstances of a case:[52]

- training and experience,
- duties and responsibilities,
- time and effort devoted to the business,
- dividend history,
- payments to nonshareholder employees,
- timing and manner of paying bonuses to key people,
- what comparable businesses pay for similar services,
- compensation agreements, and
- the use of a formula to determine compensation.

In addition to IRS officials, a majority of stakeholder representatives indicated that taxpayers were uncertain on how to meet requirements for paying shareholder compensation. Further, three of the nine stakeholder groups that we spoke with stated that inadequate shareholder compensation was one of the biggest compliance problems and that determining adequate shareholder compensation was highly subjective and depended on a number of different factors. Further, nearly all of the stakeholder representatives also indicated that having specific IRS guidance would be helpful for taxpayers and preparers.

IRS Enforcement of Adequate Shareholder Compensation Has Been Limited

Several IRS examiners told us that arriving at a justifiable conclusion about what constitutes adequate compensation can be difficult, time consuming, and result in a relatively low tax adjustment for the work involved. In determining adequate shareholder compensation, IRS examiners that we interviewed stated that they look at a variety of factors. However, due to the difficulties in determining adequate shareholder compensation, examiners said that they tend to only pursue the issue in the most egregious cases where shareholders are paid little to no wages

[52]IRS Fact Sheet, FS-2008-25 (August 2008).

and receive large distributions. A 2002 TIGTA report found that IRS examiners did not always address officer compensation, even when little to no compensation was paid.[53]

IRS efforts to enforce the rules on paying adequate wage compensation to S corporation shareholders have been limited, as shown in table 7.[54] In analyzing IRS annual examination data for fiscal years 2006 through 2008, we found that IRS only examined 0.5 percent or less of the S corporations that filed Form 1120S. IRS examined shareholder compensation usually in well less than a quarter of these examinations over these years.

Table 7: Estimated Number of S Corporation Examinations with Shareholder Compensation Issues, Examinations Closed in Fiscal Years 2006 to 2008

	2006	2007	2008
Number of S corporations filing Form 1120S	3,715,249	3,909,730	4,155,830
Number of S corporations examined	13,970	17,657	16,634
Number of S corporations examined for shareholder compensation	2,004	3,819	2,597
Percentage of all S corporations examined	0.4	0.5	0.4
Percentage of S corporation examinations that covered adequate compensation	14.3	21.6	15.6

Source: GAO analysis of IRS's Databook and EOAD data, fiscal years 2006-2008.

Note: In general, examination activity is associated with returns filed in the previous calendar year. The number of S corporations examined for shareholder compensation does not include all instances when employment tax returns (Form 941s) are examined.

When examining shareholder compensation in the NRP study, the examiners generally did not document much analysis of the adequacy of the wages paid. In our review of randomly selected NRP examination files, we found evidence of some kind of analysis to determine adequacy in 24 of 114 examinations where we noted that IRS determined that shareholder

[53]Treasury Inspector General for Tax Administration, *The Internal Revenue Service Does Not Always Address Subchapter S Corporation Officer Compensation During Examinations*, Reference No. 2002-30-125 (Washington, D.C.: July 5, 2002).

[54]Due to data limitations, we were only able to determine the number of times that examiners looked at shareholder compensation and were unable to determine how often an adjustment was made, or the amount of the adjustment.

compensation needed review.[55] These analyses included benchmarking tools such as monster.com, salary.com, and Bureau of Labor Statistics (BLS) wage data. In the other 90 examinations, examiners did not document an analysis, and in some cases merely reconciled an officer's W-2 form to the return. Examiners made adjustments in 10 of the 24 cases where documentation showed that an analysis had been made and in 16 of the other 90 cases. In these 26 examinations with adjustments due to inadequate shareholder compensation, the adjustment amount averaged $30,000.

Shareholder Compensation Issues Can be Addressed Through Legislative Options, but Potential Trade-offs Exist

Given the concerns of S corporations paying inadequate wage compensation to shareholders to avoid employment tax obligations and the burden in determining adequate compensation, legislative options have been suggested by knowledgeable groups such as the Joint Committee on Taxation and TIGTA. We analyzed the potential trade-offs in terms of the pros and cons of each option by meeting with representatives of nine organizations involved with S corporations including tax lawyers, tax accountants, and tax preparers as well as IRS officials. The pros and cons for each option are described qualitatively and are not intended to be exhaustive or weighted. As a result, we are not ranking or otherwise making recommendations on the value of each option. Appendix 1 discusses in more detail how we identified the options as well as the related trade-offs in terms of potential pros and cons.

The options we reviewed provide a different standard for determining employment tax liability than the subjective facts and circumstances criteria used to determine adequate shareholder compensation for employment tax purposes. To the extent that a new standard is clearer, S corporations and their shareholders could determine employment tax liability with less uncertainty and administrative burden, which would help ensure compliance in paying the correct employment tax amount. Similarly, clearer criteria would also help IRS examiners ensure compliance in paying all employment taxes. However, these options also include trade-offs such as increased taxes for certain S corporations and shareholders that could offset the advantages of S corporation status. Table 8 shows the options and their variations.

[55]Returns in the NRP study generally experience a higher level of examination for certain noncompliance issues such as shareholder compensation than during normal annual operations.

Table 8: Legislative Options to Address Shareholder Compensation

Type of option	Option variations
Basing employment tax liability for shareholders on the net business income reported by S corporations	• Make net business income subject to employment taxes • Make net business income for service sector businesses subject to employment taxes • Make net business income for majority shareholders subject to employment taxes
Basing employment tax liability on all types of payments made to active shareholders	• Make payments to active shareholders subject to employment tax • Make payments to active shareholders up to a dollar tolerance subject to employment tax
Retain character of income	• Retain character of income between entities

Source: GAO analysis of interviews and documents.

The first set of options attempts to reduce the burden on S corporations for paying the correct amount of employment taxes because they have to determine adequate wage compensation for each shareholder. Rather, similar to sole proprietors and partnerships, the basis for employment tax liability is shifted to the net business income reported by the S corporation. Table 9 lays out the pros and cons from using the net business income concept for employment tax purposes.

Table 9: Identified Pros and Cons of Basing Employment Tax Liability For Shareholders on the Net Business Income Reported by S Corporations

Pros	Cons
Simplifies burden by shifting to a new basis for employment taxation.	Can be considered to be unfair to impose employment tax on income that is generated beyond the services provided by a shareholder for the S corporation.
Increases uniformity of employment tax treatment by conforming S corporations and shareholders to the rules for sole proprietorships and general partners.	Shareholders could still potentially manipulate their returns to avoid employment taxes such as by incorrectly reporting a net business loss or reclassifying their business activity.
Reduces the chances for shareholders to disguise compensation as distributions, loans, or personal payments to avoid employment taxation.	S corporations may have difficulty raising capital if investor returns would be lower from having the employment tax liability.

Source: GAO analysis of interviews and documents.

From our interviews with S corporation stakeholder representatives and IRS officials, we analyzed three variations in using the net business income as the basis for employment tax liability. These variations and additional pros and cons are discussed below.

Make Net Business Income Subject to Employment Taxes. The first variation in using net business income as the basis for shareholders' employment tax liabilities in lieu of determining adequate compensation for each shareholder would make S corporation net income (whether or not distributed) subject to self-employment tax.[56] Doing so would put the shareholder's employment tax liability on par with the treatment given general partners in partnerships and to sole proprietorships. Furthermore, a 2005 JCT report estimated that this option could raise tax revenues by approximately $57.4 billion over 10 years (fiscal years 2005 to 2014).[57] However, including all net business income instead of just the wages paid to specific shareholders for the labor provided to S corporations was generally opposed by stakeholder representatives. Some stakeholder representatives stated that this shift in the method for determining employment taxation would be very dramatic or would effectively end the use of S corporation status. Additionally, some stakeholders also said that this option would be viewed as unfair for those shareholders whose income is not based on labor services provided to the S corporation.

Make Net Business Income for Service Sector Businesses Subject to Employment Taxes. The second variation would have similar pros and cons but attempt to narrow the negative impact on shareholders who provide little or no labor to the S corporation. That is, it would only apply to service sector S corporations,[58] making their net business income (whether or not distributed) subject to self-employment tax.[59] The stakeholder representatives expressed more comfort with this variation compared to the first because the employment taxes would be more likely applied to income derived from services and labor, rather than capital investment, assuming that S corporations providing services are more

[56]Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (Washington, D.C.: Jan. 27, 2005). Following the rules for partnerships, this option would exclude certain income such as rental income, dividends, and interest.

[57]JCS-02-05.

[58]Generally, service sector S corporations would include activities such as health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

[59]Joint Committee on Taxation, *Additional Options to Improve Tax Compliance* (Washington, D.C.: Aug. 3, 2006).

likely to have income generated from the labor of shareholders. In general, stakeholder representatives still opposed this option. Not all shareholders in these service corporations would necessarily provide labor services and other nonshareholder employees could be generating profits for the S corporation. Furthermore, those S corporations that are generally nonservice businesses would still have to determine adequate compensation for each shareholder. Finally, S corporations might escape this provision by simply misstating business activity as something other than a "service" business.

Make Net Business Income for Majority Shareholders Subject to Employment Taxes. The third variation for basing employment taxation on the net business income of the S corporation would be limited to only majority shareholders (those holding more than 50 percent of the stock in an S corporation).[60] This would approximate the self- employment taxation of sole proprietors. As a result, majority S corporation shareholders and sole proprietors would be put on equal footing for employment tax purposes. According to 2006 SOI data, 60 percent of all S corporations are owned by just one shareholder with almost 90 percent owned by one to two shareholders. Further, this option would help address problems with single shareholder S corporations, which have a higher incentive to underpay shareholder wages because their wage determinations are unilateral and can be structured to avoid employment taxes. For example, sole proprietors pay employment taxes on their total profits while shareholders who are the only shareholder of an S corporation are to pay employment taxes on only the amounts that they unilaterally select as their wages. This option does not change the current employment tax treatment of shareholders that hold 50 percent or less of the corporation. As a result, S corporations would still have to determine adequate compensation for those shareholders. Further, shareholders could reduce their level of ownership to less than 50 percent. In addition, it is possible that some majority shareholders provide little or no labor to the S corporation.

The second set of options shifts the basis for employment tax liability from having to determine adequate wage compensation to focusing on all types of payments made to just active shareholders. Table 10 lists the basis pros and cons of this set of options.

[60]TIGTA 2005-30-080.

Table 10: Identified Pros and Cons of Basing Employment Tax Liability on All Types of Payments Made to Active Shareholders

Pros	Cons
Reduces burden of determining adequate compensation.	Imposes employment taxes on money taken out of S corporation even if the shareholder has enough basis for a tax free distribution or pays back a loan.
Increases uniformity of employment tax treatment by conforming S corporations and active shareholders to rules for sole proprietorships and general partners.	Shareholders may be mischaracterized as "non-active," or not involved in the operation of the S corporation to avoid taxation.
Reduces the chances for shareholders to disguise compensation as distributions, loans, or personal payments to avoid employment taxation.	S corporations may funnel money through another pass-through entity to disguise active participation.
Only taxes money taken out of the corporation, which increases the likelihood for a return on capital.	May be unfair to impose employment taxes on income generated beyond the services of a shareholder.

Source: GAO analysis of interviews and documents.

Our work with the S corporation stakeholder representatives and IRS officials analyzed two variations for this set of options. The related pros and cons are discussed below for these two variations. We then discuss an additional legislative option that attempts to deal with one tax loophole related to the "character of income."

Make Payments to Active Shareholders Subject to Employment Tax. The first variation would focus on shareholders who actively participate in the operation of an S corporation and who would owe employment taxes based on all payments that they received from the S corporation including wages as well as personal payments, distributions, or loans. This option provides broad coverage in reducing the burden of determining adequate compensation and addresses the issue that the business should get some return on capital without being taxed on the investment income the shareholder leaves in the business. However, stakeholder representatives had some concerns with such coverage. For example, they said that loans made to shareholders who later pay off the loan should not be treated as income on which employment taxes are paid. As with the earlier set of options, they expressed concerns about imposing employment taxes on income generated from capital invested rather than labor provided. Furthermore, some active S corporation shareholders might still avoid taxation by treating themselves as "inactive".

Make Payments to Active Shareholders Up to a Dollar Tolerance Subject to Employment Tax. The second variation would have similar pros and cons but would attempt to limit some negative effects by inserting a dollar tolerance for all payments made to active shareholders. That is, for any shareholder who actively participates in the operation of an S corporation, all payments up to either the FICA maximum ($106,800 in 2009) or up to some other dollar amount such as double the FICA maximum ($213,600 in 2009) are considered compensation for employment tax purposes. S corporations and shareholders pay lower taxes by not paying employment taxes on all compensation. By limiting the amount of payments from the S corporation subject to employment taxation, active shareholders who have invested capital could receive a distribution free of employment taxation. In addition, this method would create a safe harbor for taxpayers wishing to ensure their compliance with shareholder compensation rules but who are uncertain of the correct income figure to report. On the other hand, this option would greatly limit flexibility in certain situations. For example, the dollar tolerance does not account for differences in payments made to active shareholders that are prompted by differences in the type of industry and geographic location, or other factors.

Retain Character of Income Between Entities. The last option we analyzed does not change the current-law basis for the employment tax obligations of shareholders. Rather, it attempts to eliminate one potential method that can be used to avoid employment taxation by using an S corporation to shelter business income from partnerships. Specifically, a partner in a partnership would attempt to circumvent the self-employment rules of partnerships by inserting an S corporation between the partnership and the individual. Under this option, income that flows from a partnership to an S corporation will retain its self-employment tax character until it is passed to an individual. By retaining the character of the income for employment tax purposes until it reaches the individual, fewer opportunities for "gaming" the system exist. However, this option only addresses one specific "loophole" and can add some complexity to track the income through different entities.

Administrative Options May Help to Decrease Inadequate Compensation Issues for S Corporations

In addition to legislative options, we identified two administrative options that may help address issues involving inadequate shareholder compensation issues while avoiding some of the cons identified above. Currently, taxpayer compliance and IRS oversight are hindered partly because of the absence of a standardized way to determine reasonable compensation on a consistent basis. Additionally, the lack of taxpayer education on shareholder compensation rules may also increase noncompliance according to some stakeholder representatives. To address these challenges, we identified these two administrative options as well as their related pros and cons which are discussed below.

Improve guidance to IRS examiners so that they might better target and determine adequate shareholder compensation. An example of the improved guidance would be to improve examiner use of tools for making adequate compensation determinations. During our review of randomly selected NRP IRS examination case files, we found that in 23 cases, examiners indicated the use of some form of analysis including 15 cases where they used salary data from the BLS or other salary tools as a benchmark for making the adequateness determination. In those cases where we saw evidence of analysis of shareholder compensation, examiners made adjustments 10 out of 23 times. When examiners used BLS statistics, they adjusted shareholder compensation 6 of 9 times. Thus, it appears that using such a tool could improve the effectiveness of IRS examinations of shareholder compensation. While the Internal Revenue Manual (IRM), IRS's official guidance resource, requires examiners to document their case review, it does not require them to conduct an analysis of shareholder compensation using tools such as BLS statistics. Additionally, the IRM does not require examiners to indicate why an analysis was not used in cases where it is excluded. An analysis, however, would not reduce the subjectivity and burden for those S corporations attempting to comply with federal rules and would not completely address the difficulty examiners face. For example, IRS officials noted that a shareholder may perform duties for the S corporation that do not align well with occupation categories available in salary benchmarking tools or may live in a location without comparable wage data.

Better educate taxpayers and provide guidance on meeting shareholder compensation tax obligations. TIGTA has recommended sending out prefiling information to taxpayers newly electing S corporation status. Some shareholder representatives told us that some taxpayers may not be aware of the need to pay officer compensation. For example some shareholder representatives noted that taxpayers or tax preparers were not certain about how to meet shareholder compensation requirements and could benefit from additional guidance through means such as additional outreach including providing information to new S corporations on shareholder compensation and improving the guidance on IRS's Web site. Even though IRS has noted that developing comprehensive guidance for S corporations can be difficult, such outreach to these unaware taxpayers could help them better determine adequate compensation for its shareholders, including those who provide capital to the S corporation but little or no labor. IRS already provides some training materials to its examiners on determining adequate compensation that goes beyond the factors developed through case law; however, these materials are not publicly available. For example, these materials encourage the use of wage benchmarking tools from third parties to help determine adequate compensation. Providing specific guidance such as this could potentially improve compliance by clarifying this issue for both taxpayers and tax preparers. Again, this better education and guidance would not resolve the subjectivity and burden associated with the "facts and circumstances" test.

Conclusions

The high percentage of noncompliant S corporations leads to substantial lost tax revenue for the federal government. Whether mistakes are intentional or unintentional, misreporting is unfair to compliant taxpayers and undermines the equity of the tax system. The high rate of misreporting associated with S corporation returns done by paid preparers raises concerns about their competency to deal with the tax complexities arising from S corporation status. New S corporation owners and their preparers may not have the appropriate skills to ensure compliance with tax rules, which can require diligent record keeping and complex basis calculations. Further, the lack of guidance on determining shareholder compensation is challenging for both taxpayers and IRS examiners. Without clear guidance or legal requirements, S corporations tend to underpay shareholder wages, resulting in underpaid employment taxes for funding programs like Medicare and Social Security. Nor are IRS examiners fully documenting or using tools that may assist them to analyze whether adequate compensation had been paid. Several options could help address these challenges, either through legislative or administrative change, although each option has its trade-offs. Any of these options should be paired with continued attention to taxpayer service and education.

Matter for Congressional Consideration

To improve compliance with shareholder basis rules, Congress should require S corporations to calculate and report shareholder's stock and debt basis as completely as possible. S corporations would report the calculation on the Schedule K-1 and send it to shareholders as well as IRS. If Congress judges that stock purchase price information that is currently only available to shareholders should not be transmitted to the S corporation due to privacy concerns, an alternative is to require that S corporations report less complete basis calculations using information already available to the S corporation.

Recommendations

To help address the compliance challenges with S corporation rules, we recommend that the Commissioner of Internal Revenue take the following four actions:

- Identify and evaluate options for improving the performance of paid preparers who prepare S corporation returns, such as licensing preparers and ensuring that appropriate penalties are available and used.
- Send additional guidance on S corporation rules and record-keeping requirements to new S corporations to distribute to their shareholders, including providing guidance on calculating basis and directing them to the specific IRS Web site related to S corporation tax rules.
- Require examiners to document their analysis such as using comparable salary data when determining adequate shareholder compensation or document why no analysis was needed.
- Provide more specific guidance to shareholders and tax preparers, such as that provided to IRS examiners, on determining adequate shareholder compensation through means such as IRS's Web site.

Agency Comments

IRS's Deputy Commissioner for Services and Enforcement provided written comments on a draft of this report in a December 4, 2009, letter, which is reprinted in appendix IV. IRS staff also provided technical comments, which we incorporated into the report as appropriate. The written comments acknowledged that S corporations represent one of the fastest growing types of businesses, that their tax misreporting can produce income tax and employment tax revenue losses, and that tax administration and compliance efforts involving S corporations can be challenging.

IRS agreed in principle with our four recommendations. Regarding the performance of paid tax preparers working on S corporation returns, IRS agreed with the need to identify and evaluate options to improve the preparers' performance and noted that by year end a team convened by the IRS Commissioner would make recommendations to strengthen oversight of tax return preparers overall. As for our recommendation on sending additional guidance to new S corporations, IRS agreed to evaluate the need for additional information to be provided on calculating stock and debt basis. Our work with S corporation stakeholders and our review of IRS examinations of the basis issue indicated that more information about calculating basis is needed. IRS also agreed to modify its correspondence to new S corporations to direct them to IRS's Web site. In addition, IRS agreed to ensure that examiners meet workpaper documentation requirements involving their analysis of comparable salary data when determining adequate shareholder compensation. IRS was silent on the second part of our recommendation under which IRS also would ensure that examiners document their rationale when they determined no analysis was needed. Our review of examiners' workpapers indicated a need for documenting why no analysis was done. We found evidence of an analysis for just 24 of the 114 examinations involving shareholder compensation, leaving open the questions of whether examiners did an analysis for the other 90 examinations and if they did, why they had not documented the analysis. Finally, IRS agreed to provide on its Web site (IRS.gov) more specific guidance to all S corporation shareholders and tax preparers on such items as recordkeeping requirements and determining adequate shareholder compensation.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its date. At that time, we will send copies of this report to the Chairman and Ranking Member, House Committee on Ways and Means; the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. This report is available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staffs have any questions about this report, please contact me at (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix V.

Michael Brostek
Director, Tax Issues
Strategic Issues Team

Appendix I: Scope and Methodology

Our objectives were to: (1) describe reasons a business might choose to become an S corporation; (2) analyze the types of S corporation noncompliance, what the Internal Revenue Service (IRS) has done to address the noncompliance overall, and options for improvement; and (3) further analyze the extent of noncompliance involving a long-standing concern over inadequate shareholder compensation, and identify options for improving compliance.

To provide background information on the size and growth of S corporations, we used IRS Statistics of Income (SOI) corporate, partnership, and individual data for tax years 2000 to 2006 to compare characteristics of S corporations to other business types. We compared our results with the published SOI files and determined our data were reliable for the purposes of our review.

To describe reasons for a business to choose S corporation status, we reviewed relevant literature from sources such as the Joint Committee on Taxation (JCT), Treasury Inspector General for Tax Administration (TIGTA), and the Congressional Research Service (CRS). We interviewed IRS officials from the Large/ Mid-Size Business Division (LMSB), the Small Business/ Self-Employed Division (SBSE), Accounts Management, and Field Assistance. We also interviewed representatives of industry organizations that have experience with S corporations, specifically: S Corporation Association (SCA), National Society of Accountants (NSA), National Association of Enrolled Agents (NAEA), Small Business Council of America (SBCA), American Institute of Certified Public Accountants (AICPA), American Bar Association (ABA), National Association for the Self Employed (NASE), National Federation of Independent Business (NFIB), and National Small Business Association (NSBA). Using the information gathered from these sources, we determined tax and nontax considerations businesses might use to choose a business entity election and used these considerations to compare the business entity types. To analyze the ability of S corporations to pass through losses to their shareholders, we used the Corporate Master File for tax years 2001 to 2006 to extract data on the number and attributes of S corporations reporting losses. We restricted our analysis to S corporations that reported losses in 2003 and filed tax returns in each year 2001 to 2006. The last line on the Form 1120S Schedule K, titled Income/Loss Reconciliation in 2006, is the amount that is carried over onto shareholders' Form 1040s as losses. However, Corporate Master File data for that line only go back to 2004. To analyze losses from 2001 to 2006, we used the 1120S Ordinary Income and Loss line to measure whether an S corporation took a loss. We also used the 2001 Individual National Research Program (NRP), a study of individual taxpayer returns conducted by IRS, to provide general information on how shareholders use S corporation income to offset other income. Based on our assessment, we determined that the Corporate Master File and Individual NRP database were sufficiently reliable for the purposes of our review.

To analyze the types of S corporation noncompliance, we used data from the 2003 and 2004 S Corporation NRP. The NRP sample is divided across 12 strata by the type of S corporation tax return filed and asset classes. IRS accepted as filed some of the NRP returns, accepted others with minor adjustments, and examined the remainder of returns either through correspondence or face-to-face meetings with taxpayers. If IRS examiners determined that taxpayers misreported any aspect of the selected tax returns, they adjusted the taxpayers' income accordingly and assessed additional taxes. Misclassification adjustments, where a taxpayer reports the correct amount but on the wrong line, are included in our analysis, as are cases where the examiner zeroed out the entire return. All estimates from the NRP S corporation underreporting study reflect the total over 2 tax years. From the S corporation NRP, 25 percent of the sample came from tax year 2003 and 75 percent from tax year 2004, but both tax years 2003 and 2004 have equal input into our estimates.

We also reviewed a random, nongeneralizable sample of 166 noncompliant cases from the S Corporation NRP to further illustrate the detailed reasons for noncompliance. These 166 cases were all returns with at least one adjustment. We requested 186 cases in May 2009, and received 175. We omitted 9 cases from our sample: 5 did not contain enough information to determine reasons for adjustments, and 4 were out of scope. We recorded information from the case files using a data collection instrument (DCI) that we developed. To ensure that our data collection efforts conformed to GAO's data quality standards, each DCI entry that a GAO analyst completed was reviewed by another GAO analyst. The reviewers compared the data recorded within the DCI entry to the data in the corresponding case file to determine whether they agreed on how the data were recorded. When the analysts' views on how the data were recorded differed, they met to reconcile any differences.

For this assessment, we interviewed IRS officials about the data, collected and reviewed documentation about the data and the system used to capture the data, and compared the information we collected through our case file review to corresponding information in the NRP database to identify inconsistencies. Based on our assessment, we determined that the

2003 and 2004 S Corporation NRP data were sufficiently reliable for the purposes of our review.

To determine what IRS has done to address the noncompliance, we interviewed IRS officials, and reviewed data from the Automated Underreporter program to determine the extent of IRS's enforcement efforts. We also used the Examination Operational Automated Database (EOAD) for tax years 2006 to 2008. Due to data reliability issues, we could only report data on how often a tax return was examined. Specifically, there were multiple entries in EOAD for one misreporting item where we could not determine whether the examiner made a correction upward, downward, or no correction to the line item. IRS officials could not tell us why or how to resolve these multiple entries. Beyond these limitations, we determined for the purposes of this review that the data we reported were reliable.

To determine some options for improvement, we interviewed IRS officials and conducted two rounds of interviews with stakeholder representatives from the S corporation industry. In the first round we compiled a list of issues relating to S corporation noncompliance and potential options for addressing noncompliance. In the second round, we provided the list compiled in the first round to the stakeholders and asked whether or not the stakeholders agreed that an issue was a problem, whether or not they agreed with the proposed solutions, and discussed the tradeoffs associated with each option. These issues, options, and trade-offs are not an exhaustive list but represent our analysis and the general views of a knowledgeable community related to S corporations. We also collected information from IRS's Web site and service programs.

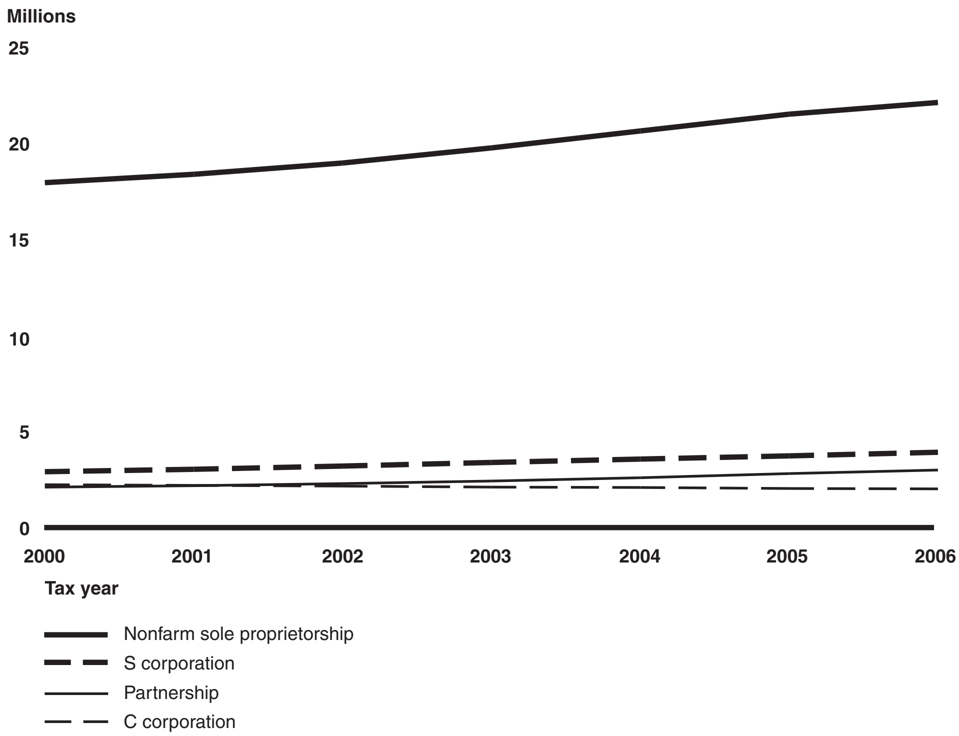
To examine the extent to which shareholder compensation contributes to S corporation noncompliance, we also used data from the S Corporation NRP and the EOAD. We also reviewed the types of shareholder compensation analysis conducted by IRS examiners in the sample of 166 cases we reviewed. To determine options for improving compliance on shareholder compensation, we spoke with experts and knowledgeable individuals on S corporation shareholder compensation issues. These experts included IRS technical advisors and other relevant staff as well as knowledgeable representatives for various national organizations that represent S corporations, tax return preparers or tax lawyers. From this work, we consolidated the list of options. Based on prior GAO reports on similar issues, a literature review of other reports, and discussions with the parties mentioned above, we developed a list of criteria for evaluating the options: equity, taxpayer impact and burden, simplicity, transparency, feasibility, and return (whether the option unduly limits potential financial returns for S corporations). We then spoke with stakeholders a second time to develop a list of pros and cons for each option based on these criteria. All percentage estimates in this report have 95 percent confidence intervals that are within +/- 8 percentage points of the estimate itself, unless otherwise specified. All other estimates in this have 95 percent confidence intervals that are within +/- 10 percent value of the estimate itself, unless otherwise specified. We conducted this performance audit from May 2007 to October 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Trends in the Growth of S Corporations

Number of S Corporations

S corporations are the second most common type of business, as shown in figure 3. In tax year 2006, 12.6 percent of all businesses were S corporations. The rate of growth of S corporations from tax year 2000 to tax year 2006 was 35 percent, while the rate of growth across all business types was 23 percent.

Figure 3: Number of Businesses by Business Type, Tax Years 2000 to 2006



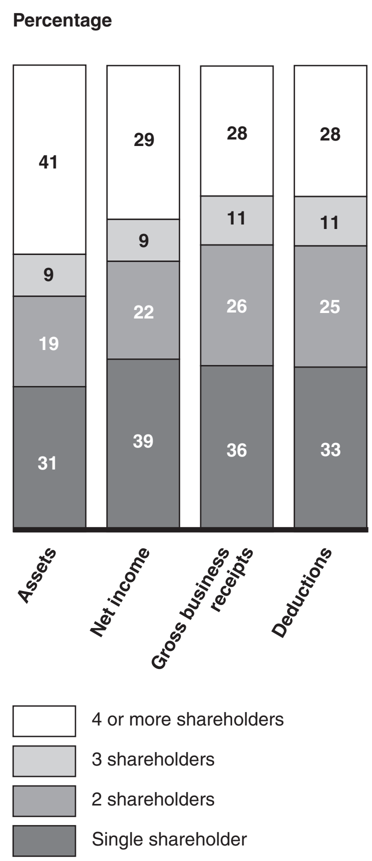
Source: GAO analysis of IRS's Statistics of Income (SOI) data.

Number of Shareholders

Most S corporations are held by three or fewer shareholders. In tax year 2006, 60 percent of S corporations were single-shareholder businesses, 89 percent had two or fewer shareholders, and 94 percent had three or fewer shareholders.

From tax years 2000 to 2006, growth in the number of S corporations with three or fewer shareholders exceeded growth in the number of S corporations with four or more shareholders. Additionally, as shown in figure 4, S corporations held by three or fewer shareholders accounted for the majority of S corporation assets, net income, gross business receipts, and deductions in 2006, and S corporations held by a single shareholder accounted for over 30 percent of S corporation assets, net income, gross business receipts, and deductions.

Figure 4: Share of Total Net Income, Business Receipts, Deductions, and Assets by Number of Shareholders, Tax Year 2006



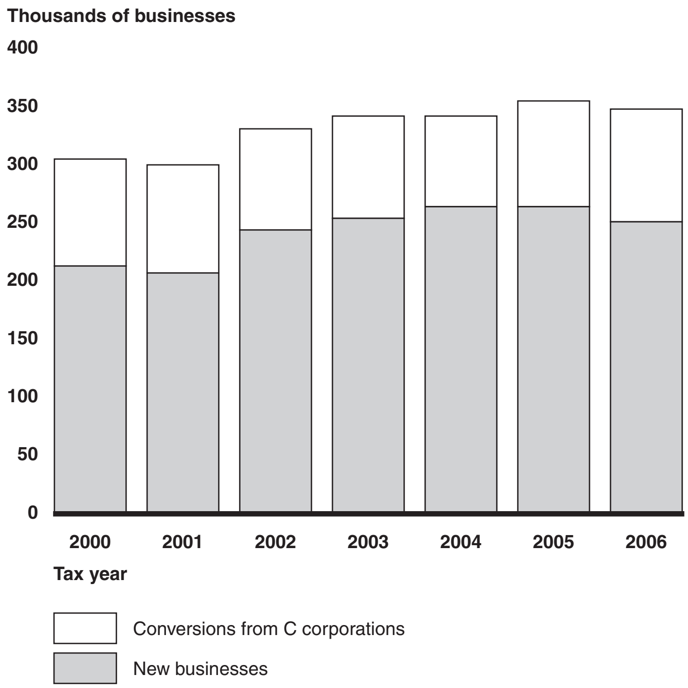
Source: GAO analysis of IRS's SOI data.

Note: Columns may not sum to 100 because of rounding.

Conversions

As shown in figure 5, between 78,000 to 97,000 C corporations converted to S corporations each year from 2000 to 2006,[1] representing 23 to 31 percent of new S corporations each year.

Figure 5: Newly Elected S Corporations, Tax Years 2000 to 2006



Source: GAO analysis of IRS's SOI data.

Note: Estimates for new businesses are within +/-9 percent of the reported values. Estimates for conversions from C corporations are within +/-14 percent of the reported values.

[1] Estimates are within +/-14 percent of the reported value.

Appendix III: Analysis of S Corporation Losses

Since nearly 70 percent of S corporations are noncompliant with tax rules and the vast majority of these underreported income, many likely took a loss when they should have reported a profit or increased the size of the loss. Because S corporation shareholders can not only offset S corporation income, but other income too (within limits), S corporation owners' noncompliance can "shelter" other income. S corporations that take losses tend to take them in multiple years, and S corporation shareholders that took losses on their tax returns in 2001 offset an average of 16.6 percent of their income with those losses. Median losses for S corporations in tax years 2001 to 2006 ranged from $277,000 to $352,000.[1]

Loss-Taking at the S Corporation Level

We examined loss and gain patterns in 2001 to 2006 for S corporations that took ordinary losses in 2003. Twenty-eight percent of the 45,450 S corporations in the 2003 SOI sample (12,651 S corporations) took losses. Of these, GAO analyzed the 9,152 that filed returns in all 6 years 2001 to 2006, to facilitate a multiyear analysis.

Of these 9,152 S corporations, 24 percent took losses in all 6 of the years, and 79 percent took losses in at least 3 of the 6 years, as shown in table 11. Additionally, 51 percent took losses in 4 or more consecutive years, as shown in table 12.

Table 11: S Corporations Taking Ordinary Losses in Multiple Years, Tax Years 2001 to 2006

Based on 9,152 S corporations that took losses in tax year 2003[a]	
Percent of S corporations claiming losses in 2003 that claimed losses in all 5 other years 2001-2006	24.02
Percent of S corporations claiming losses in 2003 that claimed losses in 4 other years 2001-2006	18.36
Percent of S corporations claiming losses in 2003 that claimed losses in 3 other years 2001-2006	19.07
Percent of S corporations claiming losses in 2003 that claimed losses in 2 other years 2001-2006	17.65
Percent of S corporations claiming losses in 2003 that claimed losses in 1 other year 2001-2006	13.02
Percent of S corporations claiming losses in 2003 that claimed losses in no other years 2001-2006	7.85

Source: GAO analysis of IRS Corporate Master File data.

[1]Adjusted to 2009 dollars.

[a]12,651 S corporations took losses in tax year 2003; GAO performed this multiyear loss analysis on the 9,152 of those that filed tax returns in all 6 years 2001- 2006.

Table 12: S Corporations Taking Ordinary Losses in Consecutive Years, Tax Years 2001 to 2006

Based on 9,152 S corporations that took losses in tax tear 2003	
Percent of S corporations claiming losses in 2003 that claimed losses in all 6 years 2001-2006	24.02
Percent of S corporations claiming losses in 2003 that claimed losses in 5 consecutive years 2001-2006	9.81
Percent of S corporations claiming losses in 2003 that claimed losses in 4 consecutive years 2001-2006	16.81
Percent of S corporations claiming losses in 2003 that claimed losses in 3 consecutive years 2001-2006	17.66
Percent of S corporations claiming losses in 2003 that claimed losses in 2 consecutive years 2001-2006	17.13
Percent of S corporations claiming losses in 2003 that did not have consecutive years of losses in 2001-2006	14.53

Source: GAO analysis of IRS Corporate Master File data

S corporation losses were substantial, as shown in table 13, ranging from a median loss of about $277,000 in 2003 to a median loss of about $352,000 in 2004.[2] Total losses claimed for all S corporations taking losses in 2003 were $11.4 billion.

S corporations that took losses in 2003 were more likely to take losses in 2002 and 2004 than in 2001, 2005, and 2006, as shown in table 13, which is not surprising since businesses tend to have periods of greater and lesser success that span multiple consecutive years.

Table 13: S Corporation Ordinary Losses, Tax Years 2001-2006, for S Corporations that Took Losses in 2003

	2001	2002	2003	2004	2005	2006
Number of S corporations claiming losses	5,200	5,966	9,071[a]	6,068	5,134	5,076
Percentage of S corporations claiming losses	57	65	99[a]	66	56	55
Median size of S corporation losses (in 2009 dollars)	$278,380	$307,938	$277,178	$351,782	$307,287	$310,124

Source: GAO analysis of IRS's Corporate Master File data.

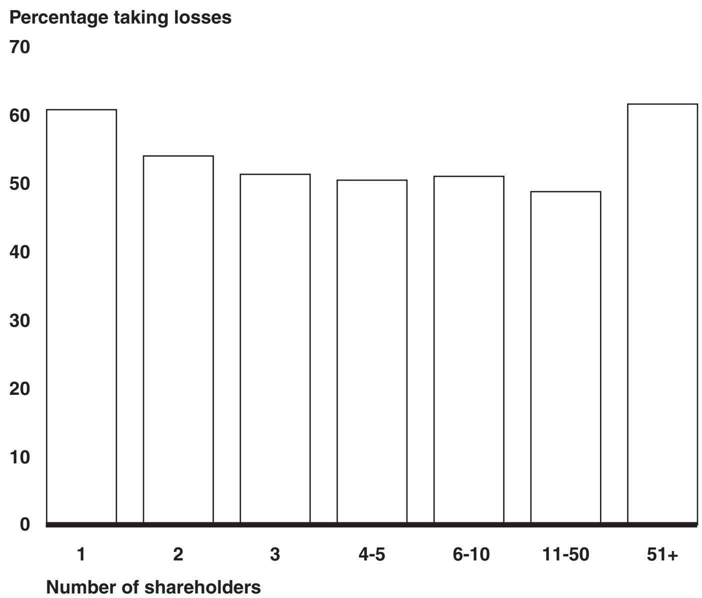
Note: Dollar amounts are adjusted to 2009 dollars.

[2]Amounts are adjusted to 2009 dollars.

[a]9,152 S corporations that took losses in 2003 were identified using IRS SOI data, and information on these businesses for tax years 2001 to 2006 was obtained from IRS Corporate Master File data. Due to minor discrepancies between these data sources, only 99% (9,071) are identified in the Corporate Master File as taking losses in 2003.

S corporation losses varied by number of shareholders, as shown in figure 6. In general, the trend is that S corporations with fewer shareholders are more likely to take losses, with the exception that very large S corporations with 51 or more shareholders are most likely to take losses.

Figure 6: S Corporation Loss Taking By Number of Shareholders, Tax Year 2006



Source: GAO analysis of IRS's Corporate Master File data.

Loss-Taking at the Shareholder Level

An analysis of shareholder Forms 1040 shows how taxpayers can benefit from taking S corporation losses. Based on an analysis of NRP data, 42 percent of taxpayers who were S corporation shareholders took a loss in 2001, with a median loss amount of $6,930.[3] As shown in table 14, total claims for all taxpayers were $40.2 billion.[4] Most losses were nonpassive: 35.7 percent of taxpayers with S corporations claimed nonpassive losses,

[3]Median loss estimate is within +/-23 percent of the reported value.

[4]Total dollar estimate is within +/-17 percent of the reported value.

with only 5.1 percent claiming passive losses. Nonpassive losses were also larger, with a median claim of $7,412, compared to a median of $2,978 for passive losses.[5]

Table 14: Total and Median Ordinary Losses Claimed by S Corporation Shareholders, Tax Year 2001

Taxpayers claiming:	Number of taxpayers	Percentage of taxpayers	Total losses claimed (billions)	Median losses claimed
Passive loss only	147,011	5.10	$3.14	$2,978[a]
Nonpassive loss only	1,028,434	35.65	$32.21	$7,412[a]
Both passive and nonpassive loss	45,217	1.57	$4.84	-[a]
No loss	1,663,852	57.68	-	-
Total	**2,884,514**	**100.00**	**$40.19**	**-**

Source: GAO analysis of IRS's 2001 NRP data.

Notes: Percentage estimates are within +/-3 percentage points. Estimates of numbers of taxpayers are within +/-37 percent of the reported value. Total dollar estimates are within +/-49 percent of the reported value. Median dollar estimates are within +/-58 percent of the reported value.

[a]The overall median loss for taxpayers claiming losses (including taxpayers with passive losses only, nonpassive losses only, and both passive and nonpassive losses) was $6,930.

Of shareholders claiming losses, 11.3 percent claimed losses for more than one S corporation. These shareholders claimed much greater amounts in losses, with a median of $27,929 claimed in losses, compared to $5,797 for shareholders claiming losses for only one S corporation.[6] Nonetheless, of the total dollars of losses claimed ($40.2 billion), most ($25.5 billion) were claimed by shareholders reporting losses for only one S corporation.[7]

Some S corporation shareholders may use losses from one S corporation to offset gains from another. Of shareholders claiming losses, 29 percent claimed gains from a different S corporation.

[5]Estimate for non-passive loss is within +/-25 percent of the reported value, and estimate for passive loss is within +/-58 percent of the reported value.

[6]Estimate for shareholders with multiple losses is within +/-37 percent of the reported value, and estimate for shareholders claiming losses for only one S corporation is within +/-27 percent of the reported value.

[7]Estimate for total losses is within +/-17 percent of the reported value, and estimate for shareholders claiming losses for only one S corporation is within +/-16 percent of the reported value.

On average, shareholders taking losses from S corporations in 2001 offset 16.6 percent of their income with S corporation losses. See table 15 for amounts of offset broken down by income brackets.

Table 15: Percentage of Non-S-Corporation Income Offset by S Corporation Losses, Tax Year 2001

Non-S-corporation income bracket	Percentage of other income offset by S corporation loss
Less than $50,000	Estimate unreliable
$50,000 - $100,000	17.6
$100,000 - $250,000	20.4
Over $250,000	10.9
Total	**16.6**

Source: GAO analysis of IRS's 2001 NRP data.

Appendix IV: Comments from the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEPUTY COMMISSIONER

December 4, 2009

Mr. Michael Brostek
Director, Tax Issues
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Brostek:

Thank you for the opportunity to review the Government Accountability Office's (GAO) draft report entitled, "Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules (GAO-10-195)."

We recognize S corporations represent one of the fastest growing business types and accounted for nearly four million businesses in 2006. We agree that S corporation misreported items and miscalculations of shareholder basis can result in revenue losses in employment taxes and individual income taxes.

We appreciate your acknowledgement of the challenges of tax administration related to S corporations and our efforts to address compliance for these entities as well as for their shareholders. We agree to provide additional guidance on the IRS website to clarify the S corporation tax rules, recordkeeping requirements, determination of adequate shareholder compensation and the shareholder's responsibility for calculating stock and debt basis. Additionally, examiners are currently required to document the consideration of the adequate shareholder compensation issue in their audit workpapers and we will reemphasize this requirement.

Your report identifies various options to help address noncompliance with S corporation tax rules and improve the performance of paid tax preparers. We are in the process of issuing recommendations that will heighten our overall oversight of paid tax preparers to improve compliance.

The enclosed response addresses each recommendation separately.

If you have questions or concerns, please contact Christopher Wagner, Commissioner, Small Business/Self-Employed Division at (202) 622-0600.

Sincerely,

Steven T. Miller

Enclosure

ENCLOSURE

Recommendation 1:
Identify and evaluate options for improving the performance of paid preparers who prepare S corporation returns, such as licensing preparers and ensuring that appropriate penalties are available and used.

Comment:
We agree in principle that we should identify and evaluate options for improving the performance of paid preparers including those who prepare S corporation returns, such as licensing preparers and ensuring that appropriate penalties are used. Commissioner Shulman's Tax Preparer Review team will be making recommendations by the end of the year which will significantly strengthen the oversight of tax return preparers.

Recommendation 2:
Send additional guidance on S corporation rules and record keeping requirements to new S corporations to distribute to their shareholders, including providing guidance on calculating basis and directing them to the specific IRS website related to S corporation tax rules.

Comment:
We agree to review current correspondence sent out upon acceptance of an S corporation election and will evaluate whether additional information is needed regarding the shareholder's responsibility for calculating stock and debt basis. We agree to modify current correspondence sent out upon acceptance of an S election to direct new S Corporations to the IRS.gov website.

Recommendation 3:
Require examiners to document their analysis such as using comparable salary data when determining adequate shareholder compensation or document why no analysis was needed.

Comment:
We currently require examiners to document in their workpapers such analysis by using comparable salary data when determining adequate shareholder compensation. We will ensure examiners comply with current workpaper documentation requirements.

Recommendation 4:
Provide more specific guidance to shareholders and tax preparers, such as that provided to IRS examiners, on determining adequate shareholder compensation through means such as IRS's website.

Comment:
We agree to provide more specific guidance to shareholders and tax preparers on IRS.gov.

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

Mike Brostek (202) 512-9110 or brostekm@gao.gov

Acknowledgments

In addition to the contact named above, Tom Short, Assistant Director; Jeff Arkin; Amy Bowser; Sara Daleski; Dewi Djunaidy; Elizabeth Fan; Katie Freeman; Eric Gorman; George Guttman; Kara Marshall; Veronica Mayhand; Brittni Milam; John Mingus; Karen O'Conor; Amy Radovich; David Reed; Matthew Reilly; Anne Stevens; Meredith H. Trauner; Brian Tremblay; Jim Ungvarsky; Walter Vance; Nick Weeks; and Jennifer Li Wong made key contributions to this report.

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