



[CLICK HERE](#) to return to the home page

Treasury Inspector General for Tax Administration (TIGTA) Audit # 200130027

Reference # 2002-30-125

A newly released TIGTA audit report entitled "The Internal Revenue Service Does Not Always Address Subchapter S Corporation Officer Compensation During Examinations" may signal the beginning of a new IRS initiative on this contentious issue.

Background.

In the C corporation context, the reasonable compensation issue is whether the entity has paid owner-employees an unreasonably high salary in order to avoid nondeductible dividend payments. In the S corporation context, the reasonable compensation issue is whether the owner-employee has been paid too little for his services in order to avoid FICA. IRS may assert that the S corp and its owner-employees have avoided paying FICA by giving officers compensation in a non-salary form, such as distributions of property, or loans.

TIGTA report says insufficient S corp compensation doesn't get enough attention. The report selected 84 S corp returns that had been examined by IRS, and which "reported officer compensation less than \$10,000 and ordinary income greater than \$50,000." For these cases, the average wages reported on Form W-2 and on Form 1120S was \$5,300, while the average Schedule M-2 distribution was \$349,323. The report concludes that this disparity suggests continued S corp underpayment of reasonable salaries to corporate officers and shareholders, and the avoidance of FICA tax. In the 13 (22%) cases in which the examiner did not address the reasonable comp issue, the reported Schedule M-2 distributions on the returns were in excess of \$12 million. Although the 13 files didn't contain adequate information necessary to estimate the actual amount of FICA taxes that should be reported on Form 941, the TIGTA report concludes that the amount that the examiner could have assessed as employment taxes to the shareholders could have been as high as \$648,065, if the entire \$12 million was misclassified as income and should have been classified as salary compensation to the officers and shareholders of the S corps.

The TIGTA report also reveals that of the 2.6 million S corp returns filed for tax year '98, 5% reported less than \$10,000 of officer compensation and also reported ordinary incomes greater than \$50,000.

Report recommendations. The TIGTA report suggests that:

. . . IRS field personnel be equipped with software to aid in determining reasonable officer compensation for a variety of occupations,

. . . Corporate distributions on Schedule M-2s be input to IRS's computer system during returns processing and thereby be made available to a master database called the "Midwest Automated Compliance System (MACS)." Classifiers flagging returns for audit could then tap into the MACS when classifying Form 1120S returns.

. . . IRS launch a nationwide initiative to track the results of S corp officer compensation examination issues.

. . . IRS develop materials to better educate and inform taxpayers and their representatives about S corp officer compensation.