

Audit Risks Increasing for Subchapter S Corporations

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I was recently interviewed by Ama Sarfo, a reporter for *Law360* (a national legal publication of LexisNexis). I discussed some of the audit risks Subchapter S corporations and their shareholders face these days. Below is an excerpt of the Article.

Audit Risk: It's estimated that the U.S. has a \$450 billion gap between taxes that are owed to the government and taxes that are actually paid on time. This staggering number, despite significant budgetary constraints, has put taxpayer compliance back in the forefront for the IRS. In the 1990s, the Service was forced to move its focus from the audit function to information and technology as its systems were terribly out of date. Taxpayers need to be on their game because the IRS is back in the audit business, and noncompliance penalties are stronger than they've ever been before.

Compensation Documentation: Subchapter S corporation exams often lead to a review of shareholder compensation. The focus is generally on whether the compensation is unreasonably low - an amorphous label that lacks a uniform standard within the courts and instead depends on questions of facts and circumstances. I advise S corporation clients, among other things, to annually document their compensation decisions and their rationale for establishing shareholder employee compensation. This would include developing a compensation methodology based on qualifications, nature of work and information about what other like companies pay similar employees. It's an art.

Loss Deductions: Shareholder basis calculations used for the purpose of absorbing losses passed through from the corporation are often reviewed in S corporation examinations. S corporations aren't required to track and report shareholder basis on IRS Form K-1 issued to shareholders each year. According to IRS studies, in a large number of cases, errors are made in this computation (it is usually user error). So, the IRS is closely scrutinizing this issue in its audits. Don't be surprised if, in the future, S corporations are required to track and report basis calculations on IRS Form K-1, just like partnerships are required to track and report capital account changes.

The law governing S corporations is ever changing. As tax practitioners, we need to keep abreast of these developments. I try to report important developments in this area of tax law on the blog.

If you would like to read the complete Article, it is available at www.Law360.com.

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