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Issue 89**WILL EFFORTS TO CLOSE THE TAX GAP IMPACT S CORPORATIONS?**

At a recent tax seminar, the speaker was asked, “What is the *tax gap*?” The speaker replied, “Regardless of what you have been told, the *tax gap* is not a clothing store for CPAs and tax attorneys!”

All kidding aside, the IRS has developed the concept of the *tax gap* as a measuring stick for taxpayer compliance with their federal tax obligations. The *tax gap* measures the extent to which taxpayers do not file tax returns and do not pay the correct amount of tax on time.

In tax year 2001, the gross *tax gap* was estimated to be \$345 Billion. Needless to say, this has gotten the attention of Washington, and it has become a priority to work toward closing the *tax gap*. How Washington goes about doing this is the real question. One possibility may be to take a closer look at S corporations.

S corporations constitute 65% of all corporate tax returns filed with the IRS. In 2006, S corporation returns stood only a 4 in 1,000 chance of being audited. In the National Taxpayer Advocate's 2007 Annual Report, it was noted that the IRS would be increasing its efforts to identify S corporation returns for examination to address possible abusive tax schemes and transactions structured to avoid tax. According to this Report, one area of focus by the IRS will be the issue of compensation versus corporate distributions.

For income tax purposes, earnings of an S corporation flow through to the shareholders on a pro rata basis. Unlike compensation, the earnings of an S corporation are not subject to self-employment tax. In essence, the S corporation saves payroll taxes, and the shareholder only pays income tax on his or her share of the earnings while avoiding Social Security and Medicare Taxes.

This favorable treatment of corporate distributions as opposed to compensation has created an opportunity for abuse. For example, it is estimated that almost one million S corporations with only one shareholder paid no compensation in 2005.

When it believes that abuse exists due to the lack of adequate compensation, the IRS has not been shy about litigating the issue. The courts have typically viewed each situation based on the substance of each transaction in light of all the evidence involved. For instance, the Tax Court and the Eastern District Court of Wisconsin held that distributions to the sole shareholder were actually wages rather than profits. The determining factor was that all of the distributions to the sole shareholder were treated as profits. Logic dictates that the avoidance of the payment of self-employment taxes cannot be achieved by characterizing all of an owner's remuneration as profits.

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