S Corp and Partnership Returns

IRS increases audit efforts

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The Treasury Inspector General of Tax Administration (TIGTA) is the watchdog of the IRS, and they are constantly examining IRS procedures. For example, in June 2012 TIGTA reported that 62 percent of audits were no-change audits of S corporation and partnership returns, which may indicate that compliant taxpayers are being burdened with unnecessary audits. However, TIGTA noted that the IRS was closing S corporation audits as no-change even though significant changes were being made to the personal returns of shareholders. This would indicate that the S corporation audits might actually be more productive than the statistics indicate.

TIGTA also discovered that the IRS was failing to do cash comparisons and finding cases where the shareholders' living expenses exceeded the income reported on their individual returns by more than $10,000. Such a considerable difference between income and expenses raises serious questions about whether the S corporation audit should have been expanded to include shareholders' individual returns.

Another audit target recommended by TIGTA is the S corporation with only one shareholder who has reported a loss of at least $25,000 in three or more consecutive years. These audits have been highly productive in terms of recommended adjustments. The IRS has been successful in generating an average of $92,000 in adjustments for each return audited.

Annually the IRS receives more than 3 million partnership returns and 4 million S corporation returns. After deducting expenses from gross income, S corporations have passed along net profits of approximately $1.8 trillion and losses of about $486 billion to their shareholders in tax years 2006 through 2010. The Service estimates that S corporations will file nearly 5.7 million returns in the 2014 tax year, a 26 percent increase over the number of S corporation returns filed in the 2010 tax year.

The popularity of S corporations has risen from the common misconception that social security taxes can be avoided by paying low salaries to officers. The IRS is specifically targeting S corporations that report income and distributions, but pay little or no salary to officers. When corporate officers perform services for the corporation and receive or are entitled to receive payments, their compensation is generally considered wages and subject to employment taxes.

The IRS is committed to using more of their audit resources to target partnerships and S corporations. Nine out of ten partnership and S corporation returns are professionally prepared. Failure to exercise due diligence can mean significant penalties for the preparer. Preparers should know that the IRS is taking the "wholesale" approach to exams. Once the IRS determines that a preparer may be filing inaccurate returns, expanding the audit to the rest of his or her clients can be an extremely profitable move for the IRS. To reduce the chances of being audited, take a common-sense approach to preparing partnership and S corporation returns and follow these recommendations:

- Verify that losses are limited to basis and the passive activity rules before being passed through to the personal tax return.
- Verify that business and personal expenses are not comingled.
- Verify that deposits are reconciled to the tax return and all income has been reported.
- Verify that the personal tax return reflects the taxpayer's lifestyle and that income and expenses are reconciled.
- Verify that all corporate filings are current by checking with the Secretary of State.
- Verify that subcontractors are properly classified as either employees or independent contractors.
- Verify that 1099s have been issued to any independent contractors.
- Verify that corporate officers are being paid reasonable wages.