



To: Clients & Friends of Pro@ctive CPA
From: Mark Wyssbrod, Managing Member
Re: IRS Eyes S-corporation Oversights
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The Internal Revenues Service (IRS) had a tax forum in Atlanta, Georgia from June 22-24, 2010. Some of the hot topics were IRS approaches to S-corporations. The IRS is finding a lack of documentation in its audits of S-corporations. This lack of proof is making for easy wins for the IRS. What are these oversights and what can you do about it? For the top 10 IRS focus points read on!

Many small businesses request to become an S-corporation for several reasons. These reasons vary from no double taxation on equity distributions (generally speaking, there are exceptions), taxed at the individual (owner) level instead using corporate tax rates and receiving income which is only subject to income tax and not self employment taxes.

However these tax advantages do come with costs. The costs range from filing an annual s-corporation tax return, filing quarterly and annual payroll tax returns, separating personal and corporate assets and behaving as a business. The IRS is finding out that small businesses are not behaving correctly and they are taking action to try to win an increase in taxes through lack of documentation and trying to invalidate the s-corporation election. The IRS believes only 25% of s-corporations are compliant. Statements from the Kiplinger Letter (May 28, 2009) backs up the IRS's non-compliant conclusion: 35,000 S-corporation did not pay compensation and over 40,000 S-corporation with profits of \$50,000 or more did not pay compensation.

First, the largest issue is the small businesses who want to be s-corporation, but never make the request and file Form 2553. Form 2553, Election by a Small Business Corporation (Under section 1362 of the Internal Revenue Code), must be filed within 75 days of the business beginning or of the date the business would like to be treated as an s-corporation. The form must be signed by an officer of the corporation and all shareholders. Revenue Procedure 2007-62 does provide guidance for first year in business corporations which missed the original 75 day window to request to become an s-corporation. Generally speaking, S-corporation qualifications include the corporation must be domestic (US), owners must be individuals (although some estates and exempt organization do qualify), the number of owners is limited to 100 owners, the owners cannot be non-resident aliens, the corporation can only have one type of ownership, each shareholder must consent to the tax treatment as an s-corporation and certain business types do not qualify. Bottom line, file Form 2553 timely if you wish to be an s-corporation!

Second, be certain you are not commingling business and personal assets. All business assets must be titled in the business name, especially if you are depreciating them. This also includes the s-corporation paying personal bills or expenditures of the owners. The IRS's position is when the s-corporation pays the personal expenses of the owner the



owner is taking compensation and not taking a distribution. The difference is self-employment taxes (Social Security and Medicare) are added to compensation. Commingling personal and corporate assets might not be a good idea if you want the legal protection of your corporation too. Commingling assets makes tracing and proving deductions difficult, which makes it easier for the IRS to win audit positions. Therefore, be certain to have business bank and credit card accounts solely for business transactions and have personal bank and credit card accounts for personal transactions.

Third, speaking of distributions, one of the s-corporation tax attractions are distributions are generally not subject to a dividend tax and the income earned to generate the distribution is not subject to self employment tax. However, following most corporate governance rules equity distributions require authorization by the Board of Directors (Board). S-corporations distributions are usually random in nature and without a Board meeting. The IRS's position is that equity distributions are approved by Board of Directors. Thus a distribution without being approved may be considered compensation. Compensation, of course, is subject to the self-employment tax which reduces the tax benefits for the owners. Be certain to have your corporate meetings and follow your corporate governance to avoid these costly mistakes and risky positions.

Fourth, keep up with corporate minutes. At a minimum have annual minutes, but you may want to meet throughout the year (monthly or quarterly) with your Board and management team. Your minutes will need to show that the Board approved to become an s-corporation, annual officer compensation and benefits, business strategy, changes to your business plan, etc. This will help to show you are following corporate governance guidelines. Additionally, one of the first items an IRS auditor will request is your annual corporate minutes. Yes, it is more paperwork, but it is the sacrifice you will need to do to avoid headaches with the IRS. It may also help you become a better business by discussing strategy on a more regular basis.

Fifth, pay your annual Secretary of State fee. Consequences of not doing so can terminate your corporation's existence. The IRS's position is that if your corporation does not legally exist your corporation cannot be treated as an s-corporation under the tax rules and regulations.

Sixth, basis must be tracked and reported on tax returns in order to claim losses from an s-corporation. Most s-corporation owners are probably asking "what's basis?" Very generally speaking, basis is the money an s-corporation owner used to purchase stock, profits taxed but left in the corporation and loans directly from the owner. The IRS continues to stress that simply guaranteeing a debt of the s-corporation does not increase basis. If the owner does not have basis then distributions could be subject to the dividend tax and losses would not be currently deductible. The IRS is discovering in their audits that owners are not properly tracking basis, are taking distributions which should be subject to the dividend tax and are taking losses which should be suspended and carried forward until basis is restored. If you want the advantages of an s-corporation, be certain to track your basis to void surprises!



Seventh, loans to and from owners require documentation. Loan documentation usually includes the date, borrower, lender, amount, interest rate, collateral (including personal guarantee) and payment terms. Generally speaking management or the Board should approve all loans. If you think you will have an interest rate of 0% you can, but for tax purposes you must impute interest. Imputed interest rates are issued by the IRS and are the rates the IRS states you have to charge related parties with balances greater than \$25,000. Not having loan documentation may allow the IRS to convert loans to shareholder into distributions subject to the dividend tax or compensation subject to Social Security and Medicare.

Eighth, compensation to officers must be adequate. S-corporation owners would like to have all distributions and no compensation. Be aware there is over 40 years of court cases to prove you must have compensation! The IRS wins these court cases by stating in court you rewarded only the owner and not the manager. So how much compensation should you pay? It all depends! Generally speaking officer compensation should be equal to or greater than the distributions taken. To determine reasonable officer compensation you will need to take into consideration the business performance, the role the owner is participating in, compensation of other key employees and the fair market value of the owner's services (i.e. how much would you have to pay another employee for similar services?). We all want to get paid, so don't forget to give yourself some compensation!

Ninth, employee benefits for greater than 2% owners must be reported on the owner's W-2. For example health insurance and health savings account (HSA) amounts must be reported on Form W-2 subject to taxable income (sometimes subject to Social Security and Medicare taxes) and report in Box 14 (a description and amount). The S-corporation gets to deduct the items as compensation to owners. The owners have to claim the compensation as income, but then get to deduction the items as self-employed health insurance and HSA contributions, respectively. The IRS issued Notice 2008-1 in December 2007 which implies they would not allow the deduction of these types of benefits if they were not reported correctly. If you want the tax benefits you will need to follow the rules!

Tenth, unreimbursed expenses cannot be deducted on Schedule E directly against income or losses. This is only allowed for owner in which are taxed as partnerships. For s-corporations, any unreimbursed expenses must be filed on Form 2106. These expenses are then reported on Schedule A as Itemized Deductions subject to a 2% of Adjusted Gross Income limitation. Bottom line: you will not receive all the benefits of the deduction you could. A better way is to turn in an expense report every month and have the business reimburse the owner for the expenses. We don't advise going longer than 60 days to turn in an expense report due to compensation rules (i.e. a reimbursement after 60 days is considered compensation subject to Social Security and Medicare from the IRS's view point).



S-corporations have a lot of tax rules and regulations. The IRS is mandating owners of s-corporation to be aware of their legal responsibilities as well. Be certain the tax joys outweigh the documentation headaches of an s-corporation.

Mark Wyssbrod, Pro@ctive CPA, has been helping small businesses achieve their goals since 1999. His proactive philosophy stems from the fact that traditional tax preparers are usually simple historians who react to their client's prior and current positions. Such a reactive stance means trying to fix mistakes after those mistakes are already made. Mark would rather prevent any mistakes in the first place. These philosophies have contributed for Mark's ability to forecast the economy accurately since he started in 2005. Mark is the Managing Member of Pro @ctive CPA and CEO of Pro @ctive Updates. You can reach Mark at (770) 664-8583.

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Internal Revenue Service Tax Forum, June 22-24, 2010, Atlanta, Georgia.

<http://www.irs.gov/pub/irs-pdf/f2553.pdf>

<http://www.irs.gov/pub/irs-pdf/i2553.pdf>

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