

5000 S Corporations to be Examined

IRS has announced it is continuing the National Research Program (NRP) this fall with examinations of 5,000 S corporations. The returns will be randomly selected from the 2003 and 2004 tax years.

According to IRS statistics there were over 3,000,000 S corporations in existence in 2002, with over 26,000 having assets more than \$10,000,000. Commissioner Everson stated, "The use of S corporations has exploded. The IRS needs a better understanding of what this means for tax compliance. This research is critical for achieving our strategic goal of ensuring that corporations and high-income individuals are paying their fair share."

IRS did not provide details of the specific areas that will be reviewed. Areas that come to our minds include:

- Distributions paid to shareholder/employees that should be reclassified as compensation.
- Shareholder basis sufficient to allow the claimed loss. (This isn't an S corporation level issue, but is related to S corporations.)
- Personal expenses being claimed on the S corporation return.
- Proper treatment of fringe benefits, such as health insurance premiums and cafeteria plans.

The NRP examinations conducted on 46,000 individual income tax returns for the year 2001 resulted in the following preliminary findings:

- Underreporting noncompliance is the largest component of the tax gap. Preliminary estimates show underreporting accounts for more than 80% of the total tax gap, with non-filing and underpayment at about 10% each.
- Individual income tax is the single largest source of the annual tax gap, accounting for about 2/3 of the total.
- More than 80% of individual underreporting comes from understated income, not overstated deductions.
- Most of the understated income comes from business activities, not wages or investment income.
- Compliance rates are highest where there is third-party reporting or withholding. Preliminary findings show less than 1.5% of wages and salaries are misreported.
- Reporting of net income from pass-through entities, such as S corporations and partnerships, has worsened between 1988 and 2001.

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David & Mary offer various fee services including consulting on Federal tax issues, speaking at seminars on various Federal topics, and assistance with the preparation of income tax returns including partial or complete returns.

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