

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



Efforts to Address the Compliance Risk of Underreporting of S Corporation Officers' Compensation Are Increasing, but More Action Can Be Taken

August 11, 2021

Report Number: 2021-30-042

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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HIGHLIGHTS: Efforts to Address the Compliance Risk of Underreporting of S Corporation Officers' Compensation Are Increasing, but More Action Can Be Taken

Final Audit Report issued on August 11, 2021

Report Number 2021-30-042

Why TIGTA Did This Audit

This audit was initiated because some S corporation owners may be motivated to underpay or not pay themselves in order to avoid paying employment taxes. Our overall objective was to determine whether the IRS's policies, procedures, and practices are adequately ensuring that compensation is considered in examinations of closely held S corporations and its shareholders.

Impact on Taxpayers

S corporation owners who do not compensate themselves and pay their fair share of employment taxes increase the burden on other taxpayers and impact the Social Security and Medicare systems.

What TIGTA Found

The issue of S corporations not paying salaries to officers and avoiding employment taxes has been reported for many years. IRS revenue agents have the opportunity to assess the issue when examining Forms 1120-S, *U.S. Income Tax Return for an S corporation*, in the field; addressing the issue more directly by examining it in the IRS's Employment Tax function; or through Compliance Initiative Projects. The IRS is selecting less than 1 percent of all S corporations for examination. When the IRS does examine S corporations, nearly half of the revenue agents do not evaluate officer's compensation during the examination even when single-shareholder owners may not have reported officer's compensation and may have taken tax-free distributions in lieu of compensation.

TIGTA's analysis of all S corporation returns received between Processing Years 2016 through 2018 identified 266,095 returns with profits greater than \$100,000, a single shareholder, and no officer's compensation claimed that were not selected for a field examination. The analysis found that the single-shareholder owners had profits of \$108 billion and took \$69 billion in the form of a distribution, without reporting they received officer's compensation for which they would have to pay Social Security and Medicare tax. TIGTA estimated 266,095 returns may not have reported nearly \$25 billion in compensation and may have avoided paying approximately \$3.3 billion in Federal Insurance Contributions Act tax.

Finally, TIGTA identified 151 S corporations with nonresident alien shareholders. S corporations are not permitted to have nonresident aliens as shareholders. If the IRS had identified these 151 S corporations and their 424 returns, it may have converted them to C corporations and assessed \$5 million in corporate income taxes.

What TIGTA Recommended

TIGTA recommended that the Commissioner, Small Business/Self-Employed Division, evaluate the risk of noncompliance associated with officer's compensation in S corporation returns and update the examination plan; evaluate the benefits to using a threshold and specific criteria as part of classification guidance; use compliance results from established workstreams to inform decision-making around alternative treatments; evaluate the 151 S corporations with nonresident alien shareholders to ensure that they meet the filing requirements for S corporations; and evaluate the benefits of creating controls to identify invalid S Corporations when shareholders are nonresident aliens.

IRS management agreed with two of the five recommendations, agreeing to issue letters to the 151 S corporations with nonresident alien shareholders asking them to review their eligibility status and analyze this population after one year. IRS management did not agree with the recommendations to evaluate the risk of noncompliance with officer's compensation and update the examination plan; evaluate the benefits of using thresholds and criteria in classification guidance; or use compliance results from established workstreams to inform decision-making.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

August 11, 2021

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Efforts to Address the Compliance Risk of Underreporting of S Corporation Officers' Compensation Are Increasing, but More Action Can Be Taken (Audit # 201930010)

This report presents the results of our review to determine whether the Internal Revenue Service's policies, procedures, and practices are adequately ensuring that compensation is considered in examinations of closely held S corporations and its shareholders. This review is part of our Fiscal Year 2021 Annual Audit Plan and addresses the major management and performance challenge of *Improving Tax Reporting and Payment Compliance*.

Management's complete response to the draft report is included as Appendix III.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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Background

S corporations are “flow-through entities” in the sense that they pass income, losses, deductions, and credits through to its shareholders for Federal tax purposes. Shareholders of S corporations report the flow-through income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations are responsible for tax on certain built-in gains and passive income at the entity level. Some S corporations’ owners may be motivated to underpay or not pay themselves in order to avoid paying employment taxes.

**Some S corporation owners
may be motivated to avoid
paying employment taxes.**

The definition of an employee for Federal Insurance Contributions Act (FICA),¹ Federal Unemployment Tax Act (FUTA),² and Federal income tax withholding under the Internal Revenue Code includes corporate officers.³ When corporate officers perform more than minor services for the S corporation and receive or are entitled to payments for those services, those payments are considered compensation. Courts have found that shareholder-employees are subject to employment taxes even when shareholders take distributions, dividends, or other forms of compensation instead of wages.⁴ In addition, the S corporation must determine and report an appropriate and reasonable salary for the shareholder(s) in these situations. Several court cases support the authority of the Internal Revenue Service (IRS) to reclassify other forms of payments to a shareholder-employee as a wage expense that are subject to employment taxes.

In December 2009, the Government Accountability Office calculated S corporation owners’ underreported compensation by \$23.6 billion in Tax Years (TY) 2003 and 2004.⁵ It reported that stakeholder representatives, one of which was tax preparer groups, indicated there was limited guidance on officer/shareholder compensation.⁶ The Government Accountability Office used IRS data to report that approximately 13 percent of S corporation owners paid inadequate compensation to avoid employment taxes.⁷ The current noncompliance rate may be much higher, as 49.5 percent of S corporations do not report any officer’s compensation.

¹ 26 U.S.C. §§ 3101-3128 (2018).

² 26 U.S.C. §§ 3301-3311 (2018).

³ Taxes under FICA are composed of old-age, survivors, and disability insurance taxes, also known as Social Security taxes, and the hospital insurance taxes, also known as Medicare taxes. FUTA, along with State unemployment systems, provides for payments of unemployment compensation to workers who have lost their jobs. The employer pays FUTA tax; it is not deducted from the employee’s wages.

⁴ *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 141 (2001). *Joly v. Commissioner*, T.C. Memo. 1998-361, aff’d by unpub. Op., 211 F.3d 1269 (2002). *Joseph M. Grey Public Accountant, P.C. vs. Commissioner*, 119 T.C. 121 (2002). *David E. Watson, PC vs. U.S.*, 668 F.3d 1008 (8th Cir. 2012).

⁵ See Appendix IV for a glossary of terms.

⁶ Other stakeholders included small business associations and legal professionals.

⁷ Government Accountability Office, GAO-10-195, *Actions Needed to Address Noncompliance With S Corporation Tax Rules* (Dec. 2009).

Subsequently, in August 2016, the U.S. Department of the Treasury's Office of Tax Analysis reported that 90 percent of S corporations have only one shareholder, and 98 percent have fewer than five.⁸ It also reported that there were 371,000 S corporation with labor costs but no issued Form W-2, *Wage and Tax Statement*, for owners or other employees.⁹

The IRS uses several approaches when it comes to S corporation compliance. Examiners within the Small Business/Self-Employed (SB/SE) Division may review officer's compensation as part of Form 1120-S, *U.S. Income Tax Return for an S corporation*, examinations. The Forms 1120-S, when examined in the field, could be looked at for any number of issues that are reported on the return, but it is not mandatory for the revenue agent responsible for the examination to review the officer's compensation issue. In addition, Exam Case Selection within the SB/SE Division's Specialty Examination function reviews the officer compensation issue. It uses the Form 1120-S along with a set of criteria to identify returns with potential employment tax noncompliance. Finally, the IRS has also used Compliance Initiative Projects (CIP) to focus resources on the issue. CIPs are authorized activities, outside of the planned strategies, with the intended purpose of correcting noncompliance around particular issues or areas of concern.

In 2009, the IRS created a CIP to address the officer's compensation issue associated with S corporations. It developed and used filters to identify high-risk cases. The CIP was eventually transitioned into the Employment Tax program workstream within the IRS's Specialty Examination function. Filters applied by Exam Case Selection identify S corporations with no officer compensation reported. Ultimately, these cases can result in an assessment to the S corporation's employment tax returns.

In August 2020, the IRS began its newest CIP associated with the lack of officer's compensation associated with S corporations. The CIP is again focused on improving compliance of S corporations that appear to have not compensated shareholders.

Results of Review

Single-shareholder S corporation owners not compensating themselves, and thus avoiding employment taxes, has been reported for many years and is an area in which the IRS has worked to improve compliance. IRS revenue agents have the opportunity to assess the issue when examining Forms 1120-S in the field or addressing the issue more directly by examining it via the Employment Tax program or CIPs. We found that the IRS's classification process appeared to have selected Forms 1120-S with the officer's compensation issue at a rate

**Underreporting and underpayment
of employment taxes contributes
\$24 billion and \$6 billion to the
Tax Gap, respectively.**

⁸ The Office of Tax Analysis working paper used unpublished 2012 IRS Statistics of Income data to make the shareholder determination.

⁹ The Department of the Treasury Office of Tax Analysis, Working Paper 107, *Paying Themselves: S Corporation Owners and Trends in S Corporation Income, 1980–2013* (Aug. 2016). This was based on 2013 data. The IRS noted that there may be a valid reason for an S corporation to not file a Form W-2, such as utilizing a third-party payer or belonging to a group of related corporations using a common paymaster.

less than the compliance risk it may present in the general population. This could explain why it is not always examined in the field when present on the return.

The Number of Examinations Evaluating Officer's Compensation May Not Align With the Compliance Risk

During our review, we found that the IRS is selecting less than 1 percent of all S corporations for examination in the field. When the IRS does examine S corporations, nearly half of the examinations completed do not evaluate officer's compensation even when the single-shareholder owners may have taken significant amounts of distributions, thus avoiding employment taxes on those portions that would have been considered compensation.¹⁰ Improvements in the IRS's classification process could help promote additional coverage of officer's compensation issues.

The IRS's latest estimate of the gross Tax Gap, the amount of tax liability not paid voluntarily and timely, was \$441 billion annually for TYs 2011 through 2013.¹¹ The gross Tax Gap is comprised of taxpayers who did not timely pay tax and timely file required returns (nonfiling), taxpayers misreporting amounts used to calculate tax liabilities on timely filed returns (underreporting), and taxpayers not paying tax liabilities reported on timely filed tax returns (underpayment).

The IRS estimates that underreporting contributes \$352 billion to the gross Tax Gap, while the underpayment Tax Gap is estimated to be \$50 billion. More specifically, underreporting and underpayment Tax Gaps associated with employment taxes are estimated to be \$24 billion and \$6 billion, respectively.¹²

The IRS has a workstream in Specialty Examination dedicated to officer's compensation

The IRS has a workstream within its Employment Tax Program that is focused on the issue of officer's compensation in S corporations. This employment tax workstream has realized average results of approximately \$17,726 per return when examining employment tax returns associated with S corporation taxpayers. As shown in Figure 1, the issue was examined 12,362 times through this workstream from Fiscal Year (FY) 2016 through FY 2018.

**Figure 1: Officer's Compensation Closures
Within the Specialty Examination Employment Tax Program**

	FY 2016	FY 2017	FY 2018
Compensation of Officers	4,406	4,398	3,558

Source: IRS Specialty Examination, Employment Tax, Program Results for FY 2016 through 2018.

¹⁰ Taxpayers may have paid some tax on the distribution personally on their Form 1040, *U.S. Individual Income Tax Return*.

¹¹ This does not reflect subsequent payments made either voluntarily or through IRS administrative and enforcement efforts. Those payments were estimated at \$60 billion, resulting in a net Tax Gap estimate of \$381 billion.

¹² IRS, Publication 1415, *Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011-2013* (Rev. 9-2019). This estimate of underreported employment taxes includes FICA and FUTA taxes. The IRS's underpayment Tax Gap associated with employment taxes includes FICA, FUTA, Self-Employment Contributions Act of 1954 (26 U.S.C. §§ 1401-1403), and the railroad retirement taxes.

The determination of whether compensation paid for services rendered by officers is reasonable is based on facts and circumstances of each case. However, the IRS advised us that its employment tax examinations generally address officer compensation cases where the officer was not treated as an employee and/or the amount of wages reported on the employment tax return was unreasonably low. Reasonable compensation cases would arise more often in connection with income tax deduction cases.

Officer's compensation is rarely evaluated during field examinations

Although the IRS has a dedicated workstream to evaluate officer's compensation issues with S corporations, the majority of S corporation examinations are performed within Field Examination. The IRS examined less than one quarter of 1 percent of S corporation filings during a field examination from FY 2017 through FY 2019. Specifically, SB/SE Field Exam examined 31,691 (0.2 percent) of the almost 14.8 million Form 1120-S returns filed from FY 2017 through FY 2019.¹³ Figure 2 contains the number of Forms 1120-S examined in FYs 2017 through 2019.

Figure 2: Form 1120-S Filings and Examinations by Fiscal Year

FY	Returns Filed¹⁴	1120-S Examined by Field Exam	Percentage
2019	5,106,459	9,556	0.2%
2018	4,848,921	9,966	0.2%
2017	4,808,833	12,169	0.3%
Totals	14,764,213	31,691	0.2%

Source: Analysis of the IRS's Compliance Presence as presented in Table 17b of the IRS Data Book. See <https://www.irs.gov/statistics/compliance-presence>.

Field Examination receives the bulk of its work as discretionary inventory through the IRS's Discriminant Function (DIF) scoring process. After DIF scoring, tax examiners evaluate the line items on the tax return during the classification process to identify the issues that will be included during the field examination. Forms 1120-S can be examined for many reasons, such as meals and entertainment, educational expenses, gifts and awards, public relations, royalties, or fuel tax credits.

Our review of examination data in the IRS's Examination Operational Automation Database (EOAD) found that officer's compensation was not examined often during a field examination of Forms 1120-S. Specifically, we found that officer's compensation was evaluated 2,846 times on

¹³ We did not include 2,397 examinations by its Correspondence Examination function. Field Examination is responsible for examination of the entity's return (*i.e.*, the S corporation's return), while Correspondence Examination is responsible for examination of the individual investor's return. These reported correspondence examinations are not direct examinations of the entity.

¹⁴ Returns filed reflect the number of returns filed the previous calendar year, as the IRS has indicated in the past that examination activity is associated with returns filed in the previous calendar year. For instance, FY 2019 examinations are conducted on Calendar Year 2018 filings.

TY 2016 and later Forms 1120-S during a field examination.¹⁵ The number of instances identified from the EOAD system for TYs 2015 through 2017 returns is shown in Figure 3.

**Figure 3: Examination Cases Identifying the
Compensation of Officers for TYs 2015 Through 2017**

	TY 2015	TY 2016	TY 2017 ¹⁶
Compensation of Officers	1,346	1,042	458

Source: Treasury Inspector General for Tax Administration's analysis of the IRS's EOAD.

Our analysis of Forms 1120-S processed from TY 2015 through TY 2017 identified 4.4 million returns (30 percent) filed as S corporations with only one shareholder and no officer's compensation reported. These 4.4 million tax returns are the potential population of tax returns that would be evaluated for officer's compensation issues.

Although the IRS cannot examine all of the 4.4 million Forms 1120-S (or even a significant percentage, given the IRS's limited compliance resources), officer compensation was selected as an issue during classification in 2,442 (14 percent) of the 17,059 S corporation examinations classified and reported in the compliance data environment. When the issue was examined in the field or as part of the employment tax workstream, we estimate that officer's compensation was examined at an average rate of 0.1 percent over a three-year period.¹⁷ As such, the IRS's examination rate of officer's compensation does not align with the potential risk.

Given the realization that this issue continues to affect taxpayers' compliance, the SB/SE Division began a national CIP in August 2020 to look at officer's compensation and distributions, with the intent to provide more resources to the issue. However, S corporation shareholders who attempt to avoid employment tax may not see this coverage as a deterrent.

Officer's compensation was not classified or examined when it met the IRS's criteria of high risk

During our review, we analyzed 3,172 closed examination cases from FY 2016 through FY 2019 for those single-shareholder S corporations with no officer's compensation and gross receipts of \$250,000 or more to determine whether the issue of officer's compensation was classified or examined. Documentation did not support that officer's compensation was classified or examined in 1,406 (44.3 percent) of 3,172 S corporation tax returns despite meeting the IRS's criteria of a "high risk" for officer's compensation. Specifically, we analyzed data reported in the

¹⁵ The EOAD provides data that tracks examination results by issue. The data can be used to enhance the ability to identify specific areas of noncompliance based on examination results. We analyzed the EOAD data for Standard Audit Index Number 512, which is defined in Internal Revenue Manual 4.10.16, Exhibit 4.10.16-2, as the Subchapter S Standard Audit Index Number associated with "compensation of officers."

¹⁶ It can take the IRS more than a year to complete examinations on Forms 1120-S; as such, it is likely that additional TY 2017 Forms 1120-S with the issue under examination remain open and may not be included in these data.

¹⁷ We calculated this based on the total TY 2015 through 2017 returns, which were likely selected for examination in the year(s) following filing, plus the total of cases closed from the compensation of officers' employment tax workstream from FY 2016 through FY 2018. We divided these totals by the number of S corporation Forms 1120-S filed during TYs 2015 through 2017, respectively, as obtained from the IRS's Statistics of Income data.

EOAD and determined that 1,406 cases were not coded with the Standard Audit Index Number (SAIN) 512 that indicates classification or examination of officer's compensation.¹⁸

We provided a judgmental selection of 20 cases to the IRS for which there was no indication of a SAIN 512. During the IRS's review of the 20 cases, it found that the S corporation issued the shareholder a Form W-2 and the shareholder reported the wages in six cases. It is possible for an S corporation to misclassify officer's compensation and include it as another expense (such as salaries and wages, cost of labor in Cost of Goods Sold, or other deductions). Although the IRS provided reasons why officer's compensation was not adjusted in some cases, we do not agree that all of these reasons should preclude an examiner from pursuing the issue. For example, we believe that officer's compensation would continue to be a productive issue in excise tax cases or in instances of corporate bankruptcy.¹⁹

Based on the IRS's review, the EOAD data are questionable as it also noted that the issue was examined in [REDACTED] of the 20 cases and adjustments to compensation were proposed in [REDACTED]. This shows the potential inaccuracies in using the EOAD system to evaluate coverage of issues and also shows that the issue is worthy of review.²⁰ At the same time, the IRS noted the EOAD is the only system that tracks issues examined, but the SAIN codes are manually selected by examiners, which leaves room for error.

The IRS is expanding its S corporation examination efforts; however, coverage of this issue can be improved

The IRS implemented a national CIP in August 2020 to focus additional resources on the issue of officer's compensation associated with S corporations. The objective of the project is to address the issue of S corporation [REDACTED]

[REDACTED] While the intent is to potentially change taxpayer behavior and bring attention to the issue for preparers nationwide, the number of returns assigned for examination during our audit (269 returns) was relatively small.

Our analysis of all S corporation returns received between Processing Years 2016 through 2018 identified 266,095 returns that were not selected for a field examination with profits greater than \$100,000 and with a single shareholder that did not report receiving officer's compensation. The analysis found that the single-shareholder owners had profits of \$108 billion and took \$69 billion in the form of a distribution, for which they would potentially have to pay Social Security and Medicare taxes if officer's compensation was reported.

¹⁸ The IRS advised that examiners may document their evaluation of an issue through other means such as comments in lead sheets or explanations in workpapers. However, the IRS also advised that the EOAD is the only way in which issues are tracked; and procedures state that capture of EOAD data is mandatory for S corporation returns and must be entered for all examined and classified issues.

¹⁹ Bankruptcies do not always dissolve Federal tax debt.

²⁰ The IRS stated that some revenue agents may consider the officer compensation issue and determine the taxpayer was in compliance without creating a SAIN 512. We were not able to get case files, so we could not independently verify the claim. Also, a review of SAIN 512 data showed many with zero amounts, possibly indicating the revenue agent recorded the SAIN 512 and did not consider the issue at all.

We estimated that the 266,095 returns did not report nearly \$25 billion in compensation, and taxpayers may have avoided paying approximately \$3.3 billion in FICA tax.²¹ As we noted previously, when corporate officers perform more than minor services for the S corporation, they are entitled to compensation. If an S corporation has a substantial amount of passive investment income or passive activity, it may not be required to pay a salary or compensation for a specific year. However, the law discourages the use of S corporations for passive investment income.²² Our analysis of the North American Industry Classification system code reported by the taxpayer identified 219,600 of the 266,095 returns that should have paid a salary to the officers. For example, these businesses include construction contractors, law offices, medical and dental offices, retail businesses, and restaurants.²³ These tax returns were not selected for a field examination despite meeting the IRS's employment tax criteria of a strong return for the officer compensation issue.

Single-shareholder owners have incentives to minimize the wages they receive in order to avoid or minimize employment taxes. Unlike wages, shareholder distributions are not subject to the employment taxes. Form 1120-S instructions are clear in that distributions and other payments by an S corporation to a corporate officer should be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation. The argument for a single shareholder not reporting compensation and receiving a tax-free distribution would be difficult. While reasonableness is important and the entirety of the distribution may not be compensation, as the sole shareholders, the owners of these companies appear to be receiving compensation without paying employment taxes.

Improvements in the classification process could help promote further coverage of the issue

Classifying or making the issue of officer's compensation mandatory for field examiners may be productive when profits, distributions, or loans to shareholders exceed a particular threshold. The IRS describes the issue of officer's compensation, as it relates to examinations of S corporations, as a "potentially productive issue" in the Internal Revenue Manual. However, there is no additional guidance provided to tax examiners during the classification process to help select productive cases with officer's compensation issues, *e.g.*, no criteria or threshold

²¹ This represents both the employer and employee portion of FICA taxes. We stratified S corporations that reported officer's compensation by their North American Industry Classification System code and profit, and then estimated potential officer's compensation for S corporations with similar codes and profit that had not reported officer's compensation on their tax returns. The IRS noted that the North American Industry Classification System codes can be unreliable, that the level of actual officer compensation can vary greatly, and that determining the amount of true compensation requires examining the facts and circumstances of each case. We acknowledge that there are many factors in estimating the loss of employment tax revenue due to noncompliance. Our estimates are intended to provide perspective as to the potential size of the issue and associated noncompliance for taxpayers that are not selected for examination but for which the information on their tax returns may indicate an increased potential for noncompliance.

²² I.R.C. § 1362(d)(3) provides that the S corporation status will terminate if the S corporation has accumulated earnings and profits at the close of three consecutive taxable years and more than 25 percent of gross receipts are passive investment income for each of the three years. Passive investment income means gross receipts derived from royalties, rents, dividends, interest, and annuities.

²³ We evaluated North American Industry Classification codes for those that may reasonably be associated with non-passive activity and as such, may require more than minor services from officers.

associated with it. Employees responsible for classifying returns are generally using their professional judgment, not personal opinions, when making return selection decisions. Formal guidance would make return classification more uniform and less subjective.

The objective in selecting returns for examination is to promote the highest degree of voluntary compliance on the part of taxpayers while making the most efficient use of finite examination staffing and other resources. Summary data provided from IRS classification subject matter experts indicated that compensation of officers was classified as an issue on Forms 1120-S 2,442 times from FY 2017 through FY 2020.²⁴ It represented 5 percent of all classified issues and 14 percent of the returns selected for examination from the population of Form 1120-S returns the IRS had in its inventory.²⁵ However, the IRS noted that the 14 percent of returns selected for examination may or may not have been assigned to a revenue agent.

In analyzing the Form 1120-S population, we determined that S corporations with single shareholders that did not report wage compensation accounted for approximately 30 percent of the returns. This is substantially higher than the rate at which the issue is being selected during classification. Compliance may be significantly impacted if Forms 1120-S that present risk are not selected at the volume or percentage represented by the total population.

In a meeting with the IRS's Office of Research, Applied Analytics, and Statistics, we were provided details of the FY 2018 pilot program to test a systemic classification process called "issue recommender." Issue recommender evaluates tax returns using algorithms to identify anomalies and commonalities among similarly situated tax returns.²⁶ While the issue recommender has not been tested on Forms 1120-S, if tested and found to be successful, it would potentially replace a manual classification process with a systemic process. During the pilot, which included individual income tax returns with varying characteristics, the issues selected for review by the issue recommender outperformed human classification of similar returns when evaluating the no-change rate and the reassignment rate.²⁷ As such, IRS management plans to expand this process to other segments of the individual tax return population.

Unlike the current classification process, the issue recommender compares the relationships between line items of a tax return among the pool of returns being considered and considers anomalies within these relationships. The issue recommender is not limited to evaluating anomalies on one tax return (which is what happens in manual classification) but is able to consider anomalies and commonalities across the pool of returns it is processing at that moment in time.

²⁴ Of the 2,442 times, 1,797 were DIF (discretionary) returns. The remainder were selected during the classification process.

²⁵ These data reflect returns classified through the IRS's Compliance Data Environment with a classification time frame of October 1, 2016, through September 30, 2020, and include only IRS activity codes associated with Forms 1120-S (234, 288, 289, and 290). The IRS's Compliance Data Environment is not used for all classification. Older fiscal years and non-DIF-scored work are the most likely to be classified outside of the Compliance Data Environment and, if classified elsewhere, would not be reflected in these summary data.

²⁶ Issue recommender evaluates tax returns that have already been scored by the DIF scoring methodology. The DIF tax return scoring models are a formula that measures and grades the risk of noncompliance and subsequently assigns a score to the return based on the potential for overall tax change to the taxpayer's return.

²⁷ The reassignment rate is associated with reassignment of returns to examiners with special expertise in an issue based on characteristics of the tax return under examination.

Efforts to Address the Compliance Risk of Underreporting of S Corporation Officers' Compensation Are Increasing, but More Action Can Be Taken

According to IRS management, the issue recommender reduces the classification time and could free up additional resources to complete additional field examinations. Specifically, examiners are taken offline and away from their examination inventory in order to classify returns. In addition to positive outcomes, such as a lower no-change rate with returns delivered by the issue recommender, keeping examiners online and engaged in their examination process saves time and money.

The Commissioner, SB/SE Division, should:

Recommendation 1: Evaluate the risk of noncompliance associated with officer's compensation in S corporation tax returns and update the examination plan to ensure that it reflects the overall risk to the population.

Management's Response: IRS management disagreed with this recommendation, stating that the SB/SE Examination Plan adequately addresses the officer compensation issue for S Corporation tax returns. They believe that the 14 percent classification rate was commensurate with compliance risk based on the Office of Tax Analysis finding that less than 9 percent of S corporations did not issue a Form W-2 to its shareholders.

Office of Audit Comment: As noted, the U.S. Department of the Treasury's Office of Tax Analysis working paper used 2013 data for its estimate. We believe the IRS should perform its own evaluation, with current tax return data and examination results, to determine a more accurate and informed estimate of noncompliance associated with the issue of officer's compensation in S corporations.

Recommendation 2: Evaluate the benefits to using a threshold and specific criteria as part of classification guidance in order to more readily identify the issue for field examinations until the issue recommender is expanded to include Forms 1120-S.

Management's Response: IRS management disagreed with this recommendation, stating that revenue agents who classify S corporation returns receive classroom and on-the-job training on the application of Subchapter S tax law and techniques to properly identify inadequate compensation. They also believe that the use of a classification threshold could require classifiers to disregard issues with potentially greater noncompliance in favor of classifying officer's compensation.

Office of Audit Comment: We do not suggest other issues with potentially greater noncompliance be disregarded when the issue of officer's compensation is classified. We believe that additional evaluation around the use of thresholds and specific criteria during the classification process may provide value to the IRS. For example, using thresholds and specific criteria to identify situations in which officer's compensation is of high risk may allow more time for classifiers to evaluate and identify other issues. In addition, consistently identifying high-risk situations may help promote a higher degree of compliance while making more efficient use of classification resources.

Compliance Results From Existing Workstreams Should Be Used When Alternative Treatments Are Considered

The use of available compliance results from the Specialty Examination function and collaborating IRS-wide could help the SB/SE Division develop alternative treatments to the issue of unreported officer's compensation. When we spoke with IRS personnel responsible for the current national CIP on officer's compensation in S corporations, they were not aware of the employment tax workstream dedicated to the issue. While the employment tax workstream is focused on the examination of employment tax returns (Form 94x, *etc.*), individuals we spoke to within the Specialty Examination function indicated that risk is assessed through analysis of the Forms 1120-S.²⁸

The CIP that began in August 2020 indicates that alternative treatments (outside of an examination) will be considered depending on the results. However, if the SB/SE Division staff responsible for the current CIP were to collaborate with those subject matter experts within the SB/SE Division's Specialty Examination function and use the results and lessons learned from the employment tax workstream, they may be able to develop examination alternatives more quickly. For example, if the IRS were to share the Form 1120-S characteristics of successful officer compensation examinations (such as significant gross receipts, lack of claimed compensation or wages, and the existence of distributions), then alternatives could be considered and potentially developed. When we proposed an alternative such as a soft notice for shareholders who did not claim compensation but for whom there is evidence of other distributions, IRS officials indicated that such communications may provide taxpayers entitlement to relief treatment under Section 530 of the Revenue Act of 1978.²⁹ IRS officials also pointed to reminders of compensation requirements in Letter 0385C, *S Corporation Election*, notifying taxpayers of S corporation election acceptance, as well as on the S corporation website on IRS.gov.

While these reminders are beneficial, there may be more proactive steps or other alternatives, such as additional reminders, the IRS can take to mitigate noncompliance when at-risk returns are filed. Specific criteria for at-risk returns could be established after further analysis of Specialty Examinations historical results, and results of the current CIP as well as past efforts could be incorporated to improve compliance of the issue. Proactive alternatives may also help to reduce reliance on the employment tax workstream dedicated to the issue, where the number of closed cases has been declining.

Recommendation 3: The Commissioner, SB/SE Division, should use compliance results from established workstreams within the Specialty Examination function, in conjunction with CIP compliance results, to inform decision-making around the consideration of proactive alternative treatments.

²⁸ Form 941, *Employer's Quarterly Federal Tax Return*, is used by employers to report income taxes, Social Security tax, or Medicare tax withheld from employee's paychecks.

²⁹ Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978). Section 530 provides employers with relief from Federal employment tax obligations if three statutory requirements are met: 1) reporting consistency, 2) substantive consistency, and 3) reasonable basis. Section 530 does not extend to the worker, who may still be liable for the employee share of FICA, not self-employment tax.

Management's Response: IRS management disagreed with this recommendation, stating that it was their practice to evaluate alternative treatments with CIP results and would do so once the CIP is complete. IRS management also stated that implementing a soft-notice process could inadvertently impact its ability to assess employment taxes with respect to a corporate officer in future years

Office of Audit Comment: As noted, the individuals we spoke to within the Specialty Examination function indicated that risk for S corporation reasonable compensation employment tax cases is assessed through analysis of the Forms 1120-S. We believe that the IRS should consider the results and analysis associated with the issue of officer's compensation from any available project or workstream. Although soft notices may not be the optimal tool to proactively mitigate potential noncompliance, considering examination results and experience from workstreams outside of the CIP may bring to light alternatives to promote tax compliance.

Some S Corporations Have Nonresident Aliens As Shareholders

During our review, we identified 151 S corporations with nonresident alien shareholders. S corporations are not permitted to have nonresident aliens as shareholders. To qualify for S corporation status, the corporation must meet the following requirements:

- Be a domestic corporation.
- Have only allowable shareholders in the form of individuals, certain trusts, and estates. Shareholders may not be partnerships, corporations, or nonresident aliens.

Our analysis of Forms 1120-S filed from Processing Years 2016 through 2018 identified 151 S corporations that issued at least one Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, to a nonresident alien shareholder. Our analysis confirmed that the nonresident aliens also filed a Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, or Form 1040NR-EZ, *U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents*.

S corporations with a nonresident alien shareholder generally require termination of the S corporation status. As such, the IRS stated that the S corporations identified during our review should be converted to a C corporation for Federal tax reporting purposes unless the election was inadvertent. While IRS management noted a [REDACTED]

If the IRS had identified these 151 S corporations and its 424 returns, it may have converted them to C corporations. C corporations are taxed at the corporate tax rate. Our calculations in Figure 4 reflect only those 217 returns (of 424) with positive income, and the maximum tax the IRS might have assessed based on the S corporation's positive income multiplied by the corporate tax rate.

Figure 4: Potential Unpaid Corporate Tax

S Corporations	FY 2015	FY 2016	FY 2017	Totals
Total 1120-S Returns With Profit	52	87	78	217
1120-S Returns With Profit	\$4,142,789	\$7,313,814	\$5,985,080	\$17,441,683
Potentially Unpaid Corporate Tax	\$1,186,723	\$2,117,296	\$1,661,696	\$4,965,714 ³¹

Source: Treasury Inspector General for Tax Administration's calculation of potential corporate income tax associated with 424 tax returns of S corporations with nonresident alien shareholders.

We did not estimate a more precise effect of converting these entities to C corporations. These S corporations may have had multiple shareholders. In addition, there may have been taxes paid by these shareholder(s) on the distributions from the S corporations, and these nonresident aliens may have paid a higher rate on their personal income tax returns. As such, the true revenue impact of conversion is unknown. Although we identified relatively few examples of this noncompliance, it is important that the IRS promote compliance and ensure the accuracy of the total tax, penalties, and interest paid to the Federal Government in accordance with the tax laws.

The Deputy Commissioner for Services and Enforcement should:

Recommendation 4: Evaluate the 151 S corporations with nonresident alien shareholders to ensure that they meet the filing requirements for S Corporations.

Management's Response: IRS management agreed with this recommendation and stated that they will issue a letter to the 151 S corporations alerting each entity to review its eligibility status.

Recommendation 5: Evaluate the benefits of creating controls to identify invalid S corporations and mitigate the risk of noncompliance when shareholders are found to be nonresident aliens.

Management's Response: IRS management agreed with this recommendation and stated that they will analyze the population from Recommendation 4 one year after the notices from their corrective action are issued to determine if additional actions are needed.

³¹ Numbers may not total due to rounding.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of our review was to determine whether the IRS's policies, procedures, and practices are adequately ensuring that compensation is considered in examinations of closely held S corporations and its shareholders. To accomplish our objective, we:

- Reviewed the Internal Revenue Code, Treasury Regulations, and internal IRS documents to determine the filing requirements and tax reporting obligations related to S corporations.
- Reviewed internal IRS documentation and interviewed applicable subject matter experts and IRS management to determine what guidance the IRS provides to revenue agents in examining Forms 1120-S and what measures and metrics are available related to S corporation examinations.
- Through the analysis of Form 1120-S data from the Treasury Inspector General for Tax Administration's Data Center Warehouse and the IRS's Audit Information Management System, identified single-shareholder S corporations with accumulated profits without indications of paying themselves reasonable compensation. We determined how many of the related Forms 1120-S were examined and evaluated and analyzed the results. To the extent possible, we estimated the potential total employment tax avoided by these S corporations.
- Evaluated the risk for fraud, waste, and abuse related to the previous testing to obtain reasonable assurance that widespread improprieties do not exist in examinations of S corporation taxpayers.

Performance of This Review

This review was performed with information obtained from the SB/SE Division offices in Lanham-Seabrook, Maryland, and Santa Clarita, California, during the period November 2019 through November 2020. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Major contributors to the report were Matthew Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations); Linna Hung, Director; Curtis Kirschner, Audit Manager; John Chiappino, Lead Auditor; Kim McMenamin, Senior Auditor; Charles Gambino, Auditor; Kevin Nielsen, Information Technology Specialist; and Laura Haws, Information Technology Specialist (Data Analytics).

Validity and Reliability of Data From Computer-Based Systems

We performed tests to assess the reliability of data from the Audit Information Management System, Business Return Transaction File, and the EOAD. We evaluated the data by (1) performing electronic testing of required data elements and (2) reviewing existing

information about the data and the system that produced them. We determined that the data were sufficiently reliable for purposes of this report.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the Internal Revenue Code, Treasury Regulations, Internal Revenue Manual, and IRS procedures, policies, and practices for the Forms 1120-S as well as its examination, including workload and case selection and performance reports. We evaluated these controls by interviewing management and revenue agents, reviewing Internal Revenue Manual procedures and other related guidance, and analyzing data from multiple IRS computer systems including the EOAD, Business Return Transaction File, and Audit Information Management System.

Appendix II

Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective action will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 151 S corporations with nonresident alien shareholders that may not meet the filing requirements of an S corporation (see Recommendations 4 and 5).

Methodology Used to Measure the Reported Benefit:

Our data analysis identified S corporations that had nonresident alien taxpayers as shareholders. S corporations were identified as those that filed Form 1120-S. Nonresident alien taxpayers were identified as individual taxpayers that filed either Form 1040NR or 1040NR-EZ. The connection between the S corporation and the taxpayers that filed nonresident returns was established by an individual shareholder's Schedule K-1 (Form 1120-S), which is filed by an S corporation.

The analysis identified 1,763 unique S corporations that provided 3,326 Schedules K-1 (for TYs 2015, 2016, or 2017) to 1,707 unique nonresident aliens who filed Forms 1040NR or 1040NR-EZ returns (any return filed during Processing Year 2016, 2017, or 2018).

Additional analysis also determined 327 of the 1,707 taxpayers that received Schedules K-1 had an Individual Taxpayer Identification Number. Of the 327 taxpayers with Individual Taxpayer Identification Numbers, 153 had repeatedly received Schedules K-1 from 151 S corporations. The 151 S corporations submitted 424 tax returns associated with the repeat Schedules K-1 to taxpayers with Individual Taxpayer Identification Numbers.

We were unable to determine a clear-cut measure of the net tax effect of converting these 151 S corporations into C corporations. These S corporations may have had multiple shareholders; in addition, there may have been taxes paid by these shareholder(s) on the distributions from the S corporations. The precise revenue impact and result of reversing those calculations and converting these entities to C corporations is unknown.

Management's Response: IRS management disagreed with this outcome measure, stating that it fails to account for S corporation shareholders who report flow-through income on their individual income tax returns (Forms 1040 or 1040-NR) when their corporation files a Form 1120-S, even when the corporation has an invalid shareholder. The IRS also notes that the net potential increase of revenue would be significantly smaller than \$4,965,715 presented in our Results of Review.

Office of Audit Comment: Although IRS management disagreed with the outcome measure, they did agree to corrective actions associated with Recommendations 4 and 5. These include issuing a letter to the 151 S

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corporations alerting each entity to review its eligibility status and analyzing these taxpayers after one year to determine if additional actions are needed. We agree with the IRS's corrective actions to protect revenue associated with these taxpayers and promote confidence in the administration of the tax code. We did not claim the potential unpaid corporate tax of \$4,965,715 as increased revenue because we were unable to determine a more precise estimate given certain variables associated with the tax returns.

Appendix III

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

July 9, 2021

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: De Lon Harris  Digitally signed by Gearl D. Harris
Commissioner, Small Business/Self-Employed Examination Date: 2021.07.09 15:46:51 -04'00'

SUBJECT: Draft Audit Report – Efforts to Address the Compliance Risk
of S Corporation Officers' Compensation Are Increasing But
More Action Can Be Taken (Audit # 201930010)

Thank you for the opportunity to review and comment on the subject draft audit report. Examining S Corporations is an important aspect of SB/SE Examination's compliance actions. An S corporation may be selected for examination due to a variety of reasons, but a notable issue considered is officer's compensation. It is important that an S Corporation shareholder adequately compensate themselves to properly pay the respective employment taxes. Shareholders report the flow-through income from the S corporation, as well as their compensation, on their personal income tax returns and pay tax at their individual tax rate. Properly compensating and reporting ensures shareholders pay their share of employment taxes.

In this report TIGTA focused on the policies and procedures utilized to classify S Corporations for examination. We rely on our highly trained workforce to exercise their professional judgment to determine which issues in an audit will be examined. Decisions to audit an issue are based on a variety of factors, including large, unusual, or questionable items. Due to the COVID pandemic, TIGTA was unable to review the complete case files, instead working from Examination Operational Automation Database (EOAD) data, which indicate how often an examiner formally pursues a particular line item on a return but do not reflect how often an examiner evaluates and determines an issue was reported correctly. Reliance on EOAD, therefore, likely understates the level of attention that IRS revenue agents applied to this issue.

We believe our existing policies and procedures properly address compliance risk regarding officer's compensation. TIGTA notes that the IRS classified officer's compensation as an issue in 14% of the S Corporation returns classified. While TIGTA estimates that 30% of S Corporation returns with single shareholders did not report wage compensation, TIGTA's estimate is based on line 7, compensation of officers, of the Form 1120-S, and the wages may have been reported elsewhere on the return

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(including line 8, salaries and wages) or paid by another entity. The Department of Treasury's Office of Tax Analysis (OTA) found that less than 9% of S Corporations did not issue a Form W-2 to its shareholder, which is a more accurate indicator of a lack of wage reporting than the "Compensation of officers" line on the Form 1120-S. As a result, the IRS believes the classification rate of 14% properly aligns with the compliance risk in the population. Expending limited IRS resources to examine more of these potentially non-compliant returns could result in little or no net tax assessed.

Attached are our comments and proposed actions to your recommendations. If you have any questions, please contact me, or Scott Irick, Director, Examination, Small Business/Self-Employed Division.

Attachment

Efforts to Address the Compliance Risk of Underreporting of S Corporation Officers' Compensation Are Increasing, but More Action Can Be Taken

Attachment

Recommendation 1:

The Commissioner, SB/SE Division, should evaluate the risk of noncompliance associated with officer's compensation in S corporation tax returns and update the examination plan to ensure that it reflects the overall risk to the population.

Planned Corrective Action:

The SB/SE Examination Plan adequately addresses the officer compensation issue for S Corporation tax returns. During FY 2017 through 2020, TIGTA notes that compensation of officers was classified as an issue in 2,442 out of 17,059 returns (14 percent). As previously discussed, the OTA found that less than 9% of S Corporations did not issue a Form W-2 to its shareholder. The 14% classification rate indicates that the IRS is identifying the issue at a rate that is commensurate with the compliance risk.

Implementation Date:

N/A

Responsible Official(s):

N/A

Corrective Action Monitoring Plan:

N/A

Recommendation 2:

The Commissioner, SB/SE Division, should evaluate the benefits to using a threshold and specific criteria as part of classification guidance in order to more readily identify the issue for field examinations until the issue recommender is expanded to include Forms 1120-S.

Planned Corrective Action:

The revenue agents who classify S corporation returns receive classroom and on-the-job training on the application of Subchapter S tax law and the use of examination techniques to properly identify inadequate compensation. As a result of this training, classifiers have the knowledge to assess whether a return presents a material risk of non-compliance and consider if no officer's compensation was deducted because another entity paid wages to the shareholder or the S corporation reported the wages on another line of the return. Classifiers may also be able to determine if the shareholder actively participated in the entity.

The objective of classification is to select the most non-compliant returns for audit and identify the most non-compliant issues on those returns. Our classification system identifies the top 2 to 3 non-compliant issues on the return based on the professional judgment of the classifier. The use of a classification threshold could require classifiers to disregard issues with potentially greater non-compliance in favor of classifying

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Officers' Compensation Are Increasing, but More Action Can Be Taken**

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officer's compensation. The examiner has the authority to expand the scope of an audit to include officer's compensation (or any other issue) if they discover non-compliance during the examination.

Implementation Date:

N/A

Responsible Official(s):

N/A

Corrective Action Monitoring Plan:

N/A

Recommendation 3: The Commissioner, SB/SE Division, should use compliance results from established workstreams within the Specialty Examination function, in conjunction with CIP compliance results, to inform decision-making around the consideration of proactive alternative treatments.

Planned Corrective Action:

It is our established practice to evaluate alternative treatments with CIP results, and we will do so once the CIP is complete.

We already provide training to our employees and public outreach to taxpayers. Letter 385-C, *S Corporation Election (Form 2553) Accepted*, notifies taxpayers of S Corporation election acceptance and includes a section that details the compensation requirements as they relate to shareholder-employees. In addition, a page on IRS.gov is dedicated to "S Corporation Employees, Shareholders and Corporate Officers" and "S Corporation Compensation and Medical Insurance Issues".

Implementing a soft-notice process could inadvertently impact the Service's ability to assess employment taxes with respect to a corporate officer in future years.

Implementation Date:

N/A

Responsible Official(s):

N/A

Corrective Action Monitoring Plan:

N/A

Recommendation 4: The Deputy Commissioner for Services and Enforcement should evaluate the 151 S corporations with nonresident alien shareholders to ensure they meet the filing requirements for S Corporations.

Planned Corrective Action:

We will issue a letter to these 151 S Corporations to alert each entity to review its eligibility status as an S Corporation.

Implementation Date:

10/15/2022

Responsible Official(s):

SBSE, Director, Examination Quality and Technical Support

Corrective Action Monitoring Plan:

IRS will monitor this corrective action as part of our internal management system of controls.

Recommendation 5: The Deputy Commissioner for Services and Enforcement should evaluate the benefits of creating controls to identify invalid S corporations and mitigate the risk of noncompliance when shareholders are found to be nonresident aliens.

Planned Corrective Action:

We will analyze the population one year after the notices are issued in Recommendation 4 to determine if additional actions are needed.

Implementation Date:

10/15/2024

Responsible Official(s):

SBSE, Director, Exam Case Selection

Corrective Action Monitoring Plan:

IRS will monitor this corrective action as part of our internal management system of controls.

Outcome Measure 1:

- Revenue Protection – Potential; 151 S corporations with nonresident alien shareholders that may not meet the filing requirements of an S Corporation (see Recommendations 4 and 5).

IRS Response:

We disagree. TIGTA acknowledges it was unable to determine the net tax effect of converting 151 S Corporations into C Corporations. We are concerned this outcome measure significantly overstates the measurable benefits on tax administration because it fails to account for S corporation shareholders who report the flow-through income on their individual income tax returns (Forms 1040 or 1040-NR) when their corporation files

a Form 1120-S, even when the corporation has an invalid shareholder. That is, the potential \$4,965,714 of income tax potentially paid by the corporations fails to account for the necessary abatement of the corresponding tax already reported and paid on the associated individual income tax returns. As a result, the net potential increase of revenue would be significantly smaller than \$4,965,714. The outcome measure also fails to account for the opportunity cost of diverting examination resources away from areas of more significant non-compliance and from more productive cases.

Appendix IV

Glossary of Terms

Term	Definition
Audit Information Management System	The Audit Information Management System is a computer system used by the Small Business/Self-Employed Division Examination Operations function and others to control returns, input assessments/adjustments to the Master File, and provide management reports.
Business Return Transaction File	Receives business tax return data, reformats and posts returns to the Return Transaction File, and does periodic file maintenance.
Compliance Data Environment	Provides a centralized information system with tax return data and other related information for IRS employees who need to analyze and deliver tax returns for examination.
Data Center Warehouse	A Data Warehouse is an architecture used to maintain critical historical data that has been extracted from operational data storage and transformed into formats accessible to an organization's analytical community.
Examination Operational Automation Database	A national database of closed examination cases that captures examination results by issue.
Fiscal Year	Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
No-Change Rate	A no-change is where all examined issues are accepted as reported.
North American Industry Classification System	The North American Industry Classification System Code, formerly called Principal Industry Activity Code, is self-coded by the taxpayer and identifies the nature of the taxpayer's business.
Passive Income	Income from a business in which the taxpayer does not materially participate.
Processing Years	The calendar year in which the tax return or document is processed by the IRS.
Reassignment Rate	Percentage of cases worked that were reassigned to a different employee group code and the percentage of reassignments that were due to an incorrect model prediction.
Revenue Agent	Employees in the Examination function who conduct face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (<i>e.g.</i> , excise tax returns).
Soft-Notice	A written notice from the IRS that requires no action on the taxpayer's part but encourages the taxpayer to check their return for errors, serving as an educational tool and improving voluntary compliance.
Standard Audit Index Number	A three-digit number that relates to the issue under examination.

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Tax Examiners	Employees in field offices who conduct examinations through correspondence.
Tax Years	The 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

Appendix V

Abbreviations

CIP	Compliance Initiative Project
DIF	Discriminant Function
EOD	Examination Operational Automation Database
FICA	Federal Insurance Contributions Act
FUTA	Federal Unemployment Tax Act
FY	Fiscal Year
IRS	Internal Revenue Service
SAIN	Standard Audit Index Number
SB/SE	Small Business/Self-Employed
TY	Tax Year



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Washington, D.C. 20044-0589

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