

S corporations facing scrutiny from the IRS

According to the *Journal of Accountancy*, the S corporation is the most popular form of business ownership in the country, swelling to around four million entities.

The primary reason for their growth is that S corporations avoid the double taxation that applies to regular C corporations while still offering protection from personal liability.

However, as their popularity increases, S corporations face greater IRS scrutiny. In particular, the IRS has focused its attention on three issues.

Shareholder-owner compensation

The basic tax rule is that compensation paid to shareholder-employees must be reasonable in amount. Historically, the IRS has questioned compensation amounts paid to C corporation owners that seemed unreasonably high. With an S corporation, a high-tax bracket owner may establish a compensation amount that is extremely low – or even zero – while increasing other pass-through income (i.e., dividends). By doing so, the owner avoids employment taxes on these payments.

The IRS recognizes the tax benefits of this strategy. Therefore, it may object to compensation that appears to be

low relative to corporate profits.

Suggestion: Have compensation reviewed before the end of the year. If appropriate, the S corporation may pay bonuses to shareholder-employees. In any event, document the reasons for compensation amounts.

Shareholder basis

Generally, a shareholder's "tax basis" for deducting corporate losses may be increased by contributing additional capital to the company, buying more stock, or lending funds to the company.

The IRS may challenge basis adjustments resulting from loans by third parties to the company. Furthermore, it has consistently maintained that a shareholder's guarantee of an S corporation debt does not increase basis.

Suggestion: Loans should be made directly from the shareholder to the S corporation, with a written note based on reasonable terms.

Fringe benefits

An S corporation may provide tax-free fringe benefits, like health insurance or employer-paid group-term life insurance coverage (up to \$50,000), to its employees. However, if an employee owning 2% or more of the company receives fringe benefits, he or she is generally taxed on the value. To avoid abuses, the IRS may examine fringe benefit packages.

Suggestion: Consider restricting benefits for owners to those that are essential or that result in minimal or no taxation (certain "working condition" benefits).

In summary, S corporation owners must be careful to observe technicalities in the tax law. For assistance, contact our office. ♦

How to spot problem accounts early

If you extend credit to your customers, some losses are inevitable. So unless you are willing to forgo the credit part of your sales, you have to figure out ways to control your bad debt losses.

Once you have extended credit to a customer, you have a stake in continuing the relationship even if you suspect there might be trouble a-brewing. You don't want to crack down on a good customer too hard too soon; yet you don't want to be "taken" by a debtor who has become unable or unwilling to pay. The problem is distinguishing between slow pay (which is bad enough) and no pay.

What you need is an early warning system to detect a credit problem in the making, so you can stop additional sales to that customer and begin collection procedures in earnest. Here are some of the tell-tale signs that point to an account that is turning sour.

- The debtor has begun paying erratically, settling up on smaller invoices while larger ones just get older, at the same time disputing specifications or terms.
- The debtor fails to return your phone calls.
- Your requests for updated financial information are ignored.
- The debtor places jumbo orders and presses you for more credit.

Any one of these signs can be the handwriting on the wall. Two or more and it's time to crack down. Take a firm stand; turn up the heat on your collection efforts, and make no more sales unless they're cash on delivery. ♦

