MEMORANDUM

September 21, 2021

To: The Office of Representative Jim Banks
   Attention: Andrew Keyes

From: Milan N. Ball, Legislative Attorney, mball@crs.loc.gov, 7-8053

Subject: IRS Audits of the President, S Corporations, and Reasonable Compensation to S Corporation Shareholder-Employees: Update of Memorandum Dated September 15, 2021

This memorandum updates a CRS memorandum dated September 15, 2021, responding to your request for information about Internal Revenue Service (IRS) audits of the individual tax returns of the President of the United States and of S corporations, and the rules governing the reasonableness of an S corporation’s compensation to a shareholder-employee. This updated memorandum responds to your additional request asking whether “presidential returns are only subject to automatic audit when they are filed while the individual is President.” The memorandum: (i) provides information about the IRS’s presidential audit program; (ii) outlines the IRS’s process for selecting S corporations for audits; and (iii) summarizes case law in which the IRS has been successful in arguing that S corporation distributions to a shareholder-employee should be reclassified as wages because the amount of wages paid to the shareholder-employee does not constitute reasonable compensation.

As detailed below, the IRS routinely audits the individual income tax returns of the President of the United States and automatically screens large S corporation returns to determine whether an audit is warranted. Further, there are no specific rules in the Internal Revenue Code or the Department of the Treasury’s regulations defining reasonable compensation to an S corporation’s shareholder-employees, but courts determining whether a shareholder-employee’s compensation is reasonable typically make their determinations based on all of the facts and circumstances of each case.¹

IRS’s Presidential Audit Program

Published IRS policies and procedures specific to the IRS’s presidential audit program and instructions to IRS employees examining the President’s individual tax returns are located in the IRS’s Internal Revenue Manual (I.R.M.).² According to the I.R.M., the IRS subjects the individual tax returns of the President of

¹ Information in this memorandum is drawn from publicly available sources and may be of general interest to Congress. CRS may thus provide all or part of this information in memoranda or reports for general distribution to Congress. If so, CRS will preserve your confidentiality as a requester.

² I.R.M. 3.25.3 (2020); I.R.M. 4.8.4.2.5 (Mar. 12, 2015). The IRS uses the Internal Revenue Manual to “document, publish, and maintain records of [its] policies, authorities, procedures, and organizational operations.” I.R.M. 1.11.6.1.2 (Apr. 8, 2020). It is
the United States to mandatory examination. The I.R.M. indicates that the IRS’s mandatory examination procedures apply to the processing of the individual tax returns and accounts of the President “in office at the time of filing.”

The House Committee on Ways and Means has sought additional information about the IRS’s practices in auditing the tax filings of the President and businesses related to the President. The Committee expressed particular concern that the limited information about IRS’s presidential audit program available to the public makes it difficult to assess the IRS’s ability to conduct full, fair, and impartial presidential audits.

**S Corporation Audit Selection**

Entities that elect S corporation tax status elect to pass their entity income, losses, deductions, and credits through to their shareholders for federal tax purposes. S corporations annually file IRS Form 1120-S, *U.S. Income Tax Return for an S Corporation*, to report their income, losses, deductions, credits, and other information. An S corporation uses IRS Schedule K-1 (Form 1120-S), *Shareholder’s Share of Income, Deductions, Credits, etc.*, to report a shareholder’s share of the S corporation’s income, losses,
deductions, credits, and other items.9 S corporation shareholders are to report the flow-through of income, losses, deductions, credits, and other items on their individual tax returns.10

There is no authority providing a comprehensive list of factors the IRS uses to determine which tax returns to select for examination. Section 3503 of the IRS Reform and Restructuring Act of 1998, P.L. 105-206, requires the IRS to incorporate into IRS Publication 1, Your Rights as a Taxpayer, a statement providing the criteria for selecting taxpayers for examination in simple and nontechnical terms.11 Publication 1 explains that the examination process usually begins in one of two ways: computer programs or outside sources.12 Computer programs identify incorrect amounts reported on returns by matching information returns (e.g., IRS Form W-2, Wage and Tax Statement, and IRS Schedule K-1 (Form 1120-S)) with tax returns and targeting tax return issues specified in IRS compliance projects or studies of past examinations.13 The IRS also may rely on information from outside sources, such as newspapers, public records, and individuals, which indicate a return is potentially noncompliant.14

IRS Publication 556, Examination of Returns, Appeal Rights, and Claims for Refund, provides additional information about the selection of returns for examination.15 Publication 556 mentions one of the computer programs used to identify returns for examination, the Discriminant Index Function system (DIF). The DIF is a mathematical technique that assigns numeric scores to processed returns for examination potential.16 The I.R.M. explains that the IRS uses the DIF to identify the returns of S corporations with less than $10 million in assets for examination potential.17 According to the I.R.M., S corporations with $10 million or more in assets are not DIF scored.18

S corporation returns with high DIF scores and the returns of S corporations with $10 million or more in assets are sent to a classifier, an experienced examiner, for screening and manual classification.19 A classifier determines (1) whether an audit is warranted, (2) the initial issues to be audited, and (3) who should conduct the audit.20 The I.R.M. indicates that classifiers should screen S corporation returns and shareholder returns for “[d]istributions and/or dividend payments made to shareholders in lieu of wages to avoid employment taxes” because it has identified this as a “potentially productive issue.”21

9 I.R.S., SCHEDULE K-1 (FORM 1120-S), SHAREHOLDER’S SHARE OF INCOME, DEDUCTIONS, CREDITS, ETC. (2020); see 26 U.S.C. § 6037(b).
10 26 U.S.C. § 6037(c).
13 Id.
14 Id.
16 I.R.M. 4.1.2.7(2) (Sept. 21, 2020); see also I.R.M. 4.1.2.7(3) (Sept. 21, 2020) (“DIF mathematical formulas are confidential and for official use only.”).
17 Id.
19 See I.R.M. 4.1.5.3.1 (Sept. 21, 2020).
20 I.R.M. 4.1.5.3 (Oct. 20, 2017); I.R.M. 4.1.5.3.1 (Sept. 21, 2020).
21 I.R.M. 4.1.5.3.6.1(4) (Oct. 20, 2017) (citing Rev. Rul. 74-44, 1974-1 C.B. 287, Small Business Corporation Dividends Paid Instead of Salaries); see U.S. DEP’T OF TREAS. INSPECTOR GEN. FOR TAX ADMIN., 2021-30-042, EFFORTS TO ADDRESS THE COMPLIANCE RISK OF UNDERREPORTING OF S CORPORATION OFFICERS’ COMPENSATION ARE INCREASING, BUT MORE ACTION CAN BE TAKEN at 4 (2021) (“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.”); see also U.S. GOV’T ACCOUNTABILITY OFF., GAO-10-195, ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES (2009).
S Corporation Shareholder-Employee Reasonable Compensation

S corporation shareholders who receive wages from their S corporation are subject to Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes, but are not subject to these employment taxes when they receive S corporation distributions and other payments. Due to this difference in treatment, S corporation shareholders have an incentive to underpay or not pay themselves wages for services rendered to their S corporations in order to avoid employment taxes. The IRS has long adhered to the position that S corporation distributions and other payments to shareholder-employees should be reclassified as wages subject to employment taxes when the amounts "are reasonable compensation for services rendered to the [S] corporation."23

In Revenue Ruling 74-44, the IRS addressed whether an S corporation’s dividend payments to its two sole shareholders should be reclassified as wages subject to employment taxes.24 In its ruling, the IRS found that the two sole shareholders had not drawn a salary and the S corporation arranged to pay them dividends in the amount they would have otherwise received as reasonable compensation for the services they performed.25 Based on these findings, the IRS concluded that the amounts paid to the shareholders constituted reasonable compensation for the services performed as opposed to a distribution of earnings and profits.26

Courts have agreed with the IRS that shareholder-employees are subject to employment taxes when shareholders take distributions, dividends, or other forms of compensation in lieu of reasonable compensation. The IRS has been successful in convincing courts to reclassify S corporation distributions and other payments as wages in cases where a shareholder-employee receives no wage compensation.28 In Joseph Radtke, S.C. v. United States, the Seventh Circuit held that dividends paid to an S corporation’s sole shareholder, Mr. Radtke, constituted wages.29 Mr. Radtke received no salary for the services he rendered to the S corporation, and, as the S corporation’s only director, he could authorize his own dividend payments.30 Similarly, in Spicer Accounting, Inc. v. United States, the Ninth Circuit considered whether dividends paid by an accounting firm electing S corporation tax status were wages

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25 Id.
26 Id.
28 See, e.g., Veterinary Surgical Consultants, 117 T.C. 141 (holding an S corporation whose only income was generated from the consulting and surgical services of its sole shareholder and officer had to recharacterize its distributions to the shareholder-officer as wages subject to employment taxes); Joly v. Comm’r, T.C. Memo. 1998-361 (recharacterizing an S corporation’s distributions to a shareholder-employee who was a reputable builder of custom homes as wages when, prior to the business’s conversion to an S corporation, the business was the reputable builder’s sole proprietorship); Sean McAlary Ltd., Inc. v. Comm’r, T.C. Summ. Op. 2013-62 (holding $83,200 of the $240,000 distribution an S corporation paid to its sole director and sole shareholder constituted wages when the shareholder-director was the only person working in the real estate firm with a real estate license).
29 Joseph Radtke, S.C., 895 F.2d 1196.
30 Id. at 1197.
subject to employment taxes. In *Spicer Accounting*, a husband and wife, Mr. and Mrs. Spicer, each owned a 50% interest in an accounting firm in which Mr. Spicer was the only accountant but was not paid wages. The Ninth Circuit held the payments to Mr. Spicer constituted wages subject to employment taxes because Mr. Spicer “performed substantial services that were essential” to the S corporation.

More recently, courts have agreed with the IRS and have reclassified distributions as wages in less obvious cases in which an S corporation’s wage compensation to a shareholder-employee was not reasonable based on the services rendered. For example, in *David E. Watson, P.C. v. United States*, the Eighth Circuit explored whether the amount of wages that an S corporation paid to its sole shareholder, Mr. Watson, was too low to constitute reasonable compensation. Mr. Watson, an accountant, transferred his 25% interest in the accounting firm he worked at to an S corporation. Thereafter, the S corporation replaced Mr. Watson as a partner in the accounting firm. While the S corporation employed Mr. Watson, Mr. Watson continued to work as an accountant exclusively for the accounting firm. In addition to being the S corporation’s sole shareholder, Mr. Watson served as the S corporation’s sole officer, director, and employee. The accounting firm made distributions to the S corporation of $203,651 in 2002 and $175,473 in 2003; the S corporation paid $24,000 to Mr. Watson as wage compensation for services rendered.

At trial, the district court held that the $24,000 paid to Mr. Watson did not constitute reasonable compensation. The district court found that the S corporation understated Mr. Watson’s wage compensation by $67,044 after adopting an IRS expert’s opinion that the market value of Mr. Watson’s services was $91,044. The IRS expert reviewed accountant compensation surveys and made adjustments to the market value of Mr. Watson’s services based on Mr. Watson’s role as an owner in the accounting firm and his receipt of fringe benefits. The Eighth Circuit upheld the district court’s ruling that the S corporation’s wage compensation to Mr. Watson did not constitute reasonable compensation based on the following evidence:

1. Watson was an exceedingly qualified accountant with an advanced degree and nearly 20 years experience in accounting and taxation;
2. he worked 35–45 hours per week as one of the primary earners in a reputable firm, which had earnings much greater than comparable firms;
3. [the accounting firm] had gross earnings over $2 million in 2002 and nearly $3 million in 2003;
4. $24,000 is unreasonably low compared to other similarly situated accountants;
5. given the financial position of [the accounting firm], Watson’s experience, and his contributions to [the accounting firm], a $24,000 salary was exceedingly low when compared to the roughly $200,000

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31 *Spicer Acct.*, 918 F.2d 90.
32 *Id.* at 91.
33 *Id.* at 93.
35 *David E. Watson, P.C.*, 668 F.3d 1008.
36 *Id.* at 1012.
37 *Id.*
38 *Id.*
39 *Id.*
40 *Id.*
41 *Id.* at 1013.
42 *Id.*
43 *Id.*
[the accounting firm] distributed to [the S corporation] in 2002 and 2003; and (6) the fair market value of Watson’s services was $91,044.44

Today, courts continue to weigh a number of factors when assessing whether S corporation compensation to a shareholder-employee is reasonable, including: (1) the shareholder-employee’s qualifications; (2) the nature, extent, and scope of the work; (3) the presence of an employment agreement; (4) the size and complexity of the S corporation’s business; (5) current economic conditions; (6) the shareholder-employee’s compensation as a percentage of gross and net income; (7) the shareholder-employee’s compensation when compared to distributions to other shareholders; (8) compensation paid to non-shareholder employees; (9) prevailing rates of compensation for comparable services; and (10) compensation paid to the shareholder-employee in previous years.45

44 Id. at 1018.