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MEMORANDUM September 21, 2021

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

From: [redacted]

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.[3] 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."[4]

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.[5] 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.[6]

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.[7] 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.[8] 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,

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also the "primary, official source of instructions to [IRS] employees relating to the organization, administration, and operation of the IRS." I.R.M. 1.11.6.1.4 (July 28, 2017).

[3] I.R.M. 3.28.3.5.3 (Nov. 17, 2020); *see also* I.R.M. 4.8.4.2.5(1) (Mar. 12, 2015).

[4] I.R.M. 3.28.3.5(1) (Jan. 1, 2020) ("Follow the instructions in this subsection of the manual when processing the individual tax returns and accounts of the President and Vice President of the United States in office at the time of filing"); *see* Ways and Means Committee's Request for the Former President's Tax Returns and Related Tax Information Pursuant to 26 U.S.C. § 6103(f)(1), 45 Op. O.L.C. __ (July 30, 2021) ("It is true that the 'mandatory audit procedures' governing the IRS's presidential audit program apply to returns filed while a President is in office." (citing Letter from Laurie Schaffer, Acting Gen. Couns., Dep't of the Treasury, to Dawn Johnsen, Acting Assistant Att'y Gen., Off. of Legal Couns., at 2 n.7 (July 16, 2021))).

[5] Compl. ¶ 80, Comm. on Ways & Means v. Dep't of the Treasury, No. 19-cv-1974 (D.D.C. July 2, 2019), ECF No. 1 ("On June 10, 2019, a bipartisan group of Committee staff members met with Treasury and IRS officials to discuss the Presidential audit program. None of the Treasury or IRS officials at the meeting had ever been involved in an actual Presidential audit. The officials declined to discuss any tax return information pertaining either to President Trump or to any of the other Presidents dating back to 1977 whose returns Committee staff inquired about in an effort to understand how the Presidential audit procedures are implemented by the IRS. Instead, the officials gave Committee staff a basic overview of the applicable provisions in the Manual, while bluntly admitting that these provisions were outdated and diverged in numerous respects from current practice.").

[6] *Id.* ¶ 81 ("The limited information communicated raised more questions for the Committee about the Presidential audit program and whether it should be codified into law in some appropriate form. For example, Treasury and IRS officials stated that, generally, a single IRS agent determines the scope, depth, and direction of each Presidential audit based on the agent's own personal discretion. Although the identity of that individual is largely secret within the IRS, it is known to the President or the President's representative—because the IRS agent is required to meet with one or both at the start of the audit—heightening concerns as to whether the individual IRS agent tasked with auditing the President is adequately shielded from undue political interference and pressures. In addition, the briefing confirmed that there are no special procedures in the Presidential audit program for handling highly complex returns or for a grantor trust . . . ."); *see* Letter from Richard E. Neal, Chairman, Comm. on Ways and Means, U.S. House of Representatives to Janet L. Yellen, Sec'y of the Treasury, et al., at 3 (June 16, 2021) ("At its core, what the Committee seeks to understand is how the IRM provisions have been applied *in practice* and whether IRS agents have been able to act objectively in the past. Specifically, the Committee requires information about an actual audit and an actual taxpayer. This will help the Committee determine, among other things: (i) whether IRS agents have been able to operate free from improper interference by a President or his representatives; (ii) whether agents have looked at ongoing audits that predate a President's term in office; (iii) whether agents have reviewed underlying business activities, especially activities involving many interrelated entities and income from and deductions related to foreign sources; (iv) whether agents have had access to the necessary books and records to substantiate amounts on the tax return; (v) whether there have been any examination findings or adjustments and how a President has responded to such findings or adjustments; and (vi) whether agents have had access to the necessary resources to undertake an exhaustive review of a complex taxpayer on an annual basis.").

[7] 26 U.S.C. §§ 1361-1379, 6037.

[8] I.R.S., FORM 1120-S, US INCOME TAX RETURN FOR S CORPORATION (2020); *see* 26 U.S.C. § 6037(a).

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]

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[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).

[11] 26 U.S.C. § 7801 note.

[12] I.R.S., PUBLICATION 1, YOUR RIGHTS AS A TAXPAYER (2017).

[13] *Id*.

[14] *Id*.

[15] I.R.S., PUBLICATION 556, EXAMINATION OF RETURNS, APPEAL RIGHTS, AND CLAIMS FOR REFUND (2013).

[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*.

[18] I.R.M. 4.1.2.7.4(1) (Oct. 19, 2017).

[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.[22] 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.[27] 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

[22] 26 U.S.C. §§ 3111, 3301; *see* 26 U.S.C. §§ 3121(a), 3306(b).

[23] I.R.S., 2020 INSTRUCTION FOR FORM 1120-S (2021).

[24] Rev. Rul. 74–44, 1974-1 C.B. 287.

[25] *Id*.

[26] *Id.*

[27] David E. Watson, P.C. v. United States, 668 F.3d 1008 (8th Cir. 2012), *cert. denied*, 568 U.S. 888 (2012); Joseph Radtke, S.C. v. United States, 895 F.2d 1196 (7th Cir. 1990); Spicer Acct., Inc. v. United States, 918 F.2d 90 (9th Cir. 1990); Veterinary Surgical Consultants, P.C. v. Comm'r, 117 T.C. 141 (2001), *aff'd*, 54 Fed. App'x 100 (3d Cir. 2002); Joly v. Comm'r, T.C. Memo. 1998–361, *aff'd without published opinion*, 211 F.3d 1269 (6th Cir. 2000); *see also* Joseph M. Grey Public Acct., P.C. vs. Comm'r, 119 T.C. 121 (2002).

[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.[31] 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.[32] 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.[33]

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.[34] 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.[35] Mr. Watson, an accountant, transferred his 25% interest in the accounting firm he worked at to an S corporation.[36] Thereafter, the S corporation replaced Mr. Watson as a partner in the accounting firm.[37] While the S corporation employed Mr. Watson, Mr. Watson continued to work as an accountant exclusively for the accounting firm.[38] In addition to being the S corporation's sole shareholder, Mr. Watson served as the S corporation's sole officer, director, and employee.[39] 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.[40]

At trial, the district court held that the $24,000 paid to Mr. Watson did not constitute reasonable compensation.[41] 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.[42] 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.[43] 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

[31] *Spicer Acct.*, 918 F.2d 90.

[32] *Id.* at 91.

[33] *Id.* at 93.

[34] David E. Watson, P.C. v. United States, 668 F.3d 1008 (8th Cir. 2012), *cert. denied*, 568 U.S. 888 (2012); Herbert v. Comm'r, T.C. Summ. Op. 2012-124 (recharacterizing some business expenses as wages after finding the $2,400 salary of an S corporation shareholder-employee "unreasonably low"); *see also* Nu-Look Design, Inc. v. Comm'r, 356 F.3d 290 (3d Cir. 2004), *cert. denied*, 543 U.S. 821 (2004).

[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.

[45] Joly v. Comm'r, T.C. Memo.1998–361 (citing Kennedy v. Comm'r, 671 F.2d 167, 173–74 (6th Cir. 1982)); Sean McAlary Ltd., Inc. v. Comm'r, T.C. Summ. Op. 2013-62.