Are There Changes on the Horizon for S-Corporations?

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A group of influential tax lawyers is fighting with the government over a report they fear may be used to raise taxes on the many small U.S. businesses set up as S corporations.

The report says that so-called S corps—widely used by doctors, lawyers and other professionals, as well as entrepreneurs in a range of fields—dodge taxes through misreporting and underpay employment taxes by billions of dollars each year.

A challenge to those findings has been intensifying since January, when they were published by the Government Accountability Office. Members of an American Bar Association tax group say the report is misleading and inaccurate, and most recently enlisted the help of Sen. Russ Feingold (D., Wis.) to get Congress to release supporting data.

So far, the GAO has defended its findings and refused the data requests.

Tax advisors, including accountants and members of the ABA group, are concerned the report's damning conclusions make S corps a target for officials looking for places to raise taxes. In a worst-case scenario, the fear is it might be used to shut them down altogether.

Already, the prospect of higher taxes in a fragile economy has had a chilling effect on S corps, they say, with business owners slowing or stopping hiring altogether.

S corps are a common and growing type of business. Most are held by three or fewer shareholders, according to the report. Their ranks grew by 35% from tax year 2000 to 2006, to total nearly 4 million businesses in 2006. Their total assets grew by 46%, or $1 trillion. In 2006, S corps were the second most common business type after sole proprietorships.

S corps are taxed under subchapter S of the tax code, which lets a shareholder claim losses and deductions to offset other income earned; that is limited, however, up to the amount of basis the person has in the S corps stock and debt. As employers, S corps must pay and withhold for employment taxes on wages. Unlike partnerships and sole proprietorships, S corps can pay both wages and distributions to shareholders, but only wages are subject to employment taxes.

Thomas J. Nichols, chair of the Committee on S Corporations of the American Bar Association Tax Section, has been trying to get Senate Finance Committee leaders Max Baucus (D., Mont.) and Charles Grassley (R., Iowa), who ordered the report, to authorize the GAO to consent to release supporting data. In one of a series of letters to the senators provided to Dow Jones Newswires, Nichols said he "was shocked" by the report which, he said, implies that S corps "are aberrantly noncompliant with the Tax Code."

In an interview, Nichols said he is not so much worried that the government would "tinker with the rules, but that it would tinker with them in a way that is not transparent."

In one of his letters, Nichols questions a finding in the report that an estimated 68% of S corp returns filed for tax years 2003 and 2004 misreported at least one item affecting net income. From that and other data, the report deduces long-standing problems with S corp tax compliance. Nichols says that conclusion seems unwarranted.

GAO official Timothy P. Bowling, in a letter published last month in the trade publication Tax Notes, says the agency stands behind its "objective and fact-based work."

Whether due to numerous small errors or fewer large errors, "the $85 billion net misreporting of income for the 2003 and 2004 period suggests to us consequential noncompliance that, if possible, should be cost-effectively addressed," Bowling wrote.

The GAO could not immediately be reached for comment for this article.