# A TAX POLICING PARADOX

*Richard Winchester*[*]

ABSTRACT

I.R.S. audits consistently fail to scrutinize a form of tax evasion called the S corporation employment tax dodge. It occurs when an S corporation pays an employee-owner an amount that is classified as a dividend when it should be classified as compensation for their work. A dividend does not trigger employment tax while a salary does. Even when there is ample reason to suspect that a dividend is nothing more than disguised compensation, I.R.S. audits regularly don't question whether the firm properly classified the payment. That's because the law governing this area is subjective and fact-specific, which makes it costly and time-consuming to enforce. In addition, the effort it takes to enforce the law frequently is not worth the revenue the agency might collect. So, unless the I.R.S. defies this cost-benefit assessment, any additional money invested to audit more S corporations will simply mean more firms will escape detection. That, in turn, will fuel more employment tax evasion by S corporations – not less – because studies show that if a tax audit fails to detect a specific form of tax evasion, the audited taxpayer will continue to engage in the practice that went unnoticed, while other taxpayers will begin doing so as word spreads that the risk of detection is low. This tax policing paradox would not exist if Congress enacted an objective rule to replace the subjective one that now applies to determine a shareholder's compensation. Taxpayers will be more likely to obey such a rule, and the I.R.S. will be more likely to enforce it.



[*] Professor of Law, Brooklyn Law School; J.D., Yale Law School; A.B., Princeton University.

## Introduction

Policing taxpayers for compliance with the tax laws can be tricky, especially when the tax system relies on taxpayers to voluntarily fulfill their taxpaying obligations. That's how the U.S. federal income tax system operates. The government does not send taxpayers an annual bill indicating the amount they are expected to pay. Instead, taxpayers are required to take the initiative by determining what they owe in tax. This requires a level of honesty (and accuracy) that the government cannot expect every taxpayer to meet. That's where tax policing enters the picture in the form of the income tax audit. If the government wanted to assure itself that every taxpayer honestly and correctly determined and paid their tax bill, the government would have to audit every taxpayer every year. However, that is simply not possible. So, the government relies on several different mechanisms to achieve something approaching universal compliance.

Perhaps the mechanism that most individuals are familiar with is the practice of requiring tax to be withheld from certain payments received by taxpayers. This is what happens with compensation received from an employer. The employee does not receive the entire amount that they earned. A certain amount is withheld by the employer, paid over to the government, and applied to satisfy the employee's income tax liability for the year. The mechanism is imperfect in one respect: the amount withheld rarely – if ever – matches the employee's tax liability for the year. If the amount withheld exceeds the taxpayer's liability, the government sends the taxpayer a refund. If their liability exceeds the amounts withheld, the taxpayer is expected to pay the difference. Still, the mechanism is remarkably effective in assuring that taxpayers do not underpay what they owe in tax on their earnings from work.

But withholding is not possible in every situation. One such instance is when a taxpayer derives income from operating a business. In those cases, the taxpayer is expected to determine in the first instance how much tax they owe. At a minimum, this involves disclosing all sources of income and offsetting that amount by deductions that are permitted to be claimed. The process necessarily relies on taxpayers to be both honest and accurate. But human nature being what it is, that is unlikely to be the case for every taxpayer. And, when the population of taxpayers is as large as the one in the U.S., discrepancies on a meaningful share of tax returns can add up to billions of dollars in uncollected revenue.

Putting that aside, when certain taxpayers fail to satisfy all of their taxpaying obligations, the people who do end up bearing more than their fair share of the burden to support the government.

So, in the absence of universal annual audits, the government has adopted a second-best approach to address the situation, which is to audit a small number of carefully selected taxpayers, generally based on an assessment of the risk that the taxpayer may not be complying with their tax obligations. This is expected to accomplish at least two things. First, if the audited taxpayer has, indeed, failed to correctly determine what they owe in tax, the discrepancy can be corrected for the year under audit. Second, that taxpayer will (hopefully) not file returns that contain the same discrepancy going forward. Selected audits also have a third – and perhaps more important – impact. When the government observes a practice of auditing a select number of tax returns, vast numbers of taxpayers will be discouraged from ever evading their taxpaying obligations. This is especially true if the government publicizes the practice and prosecutions of taxpayers who have failed to meet their obligations.

However, all of this is premised on the assumption that tax audits in fact scrutinize, detect and address instances of tax evasion or abuse. If a particular form of tax evasion is not questioned, an audit will have just the opposite effect on taxpayer behavior. The taxpayer in question will not face any consequences for their failure to comply with the law. As a result, they will be more likely to engage in the practice that went undetected going forward. And, other taxpayers will start to engage in the practice as word begins to spread that it does not seem to attract any scrutiny or punishment. This is what I refer to as a tax policing paradox. More audits lead to less taxpayer compliance with a specific rule when the government does not scrutinize taxpayer compliance with the rule in the course of an audit.

There is one specific form of tax evasion that is unlikely to receive the scrutiny it deserves during an I.R.S. audits. It is called the S corporation employment dodge. It is available whenever the firm is a closely held corporation that has elected to be treated as a quasi-partnership under the rules of subchapter S of the Internal Revenue Code. The tax dodge generally works like this. If the firm has an owner who also works for the firm, that individual can access the company's earnings in two ways. The firm can pay them a salary or some other form of compensation for their work. The firm can also distribute the earnings to them as a dividend on their stock. The employee-owner would have to pay income tax on both payments. However, federal employment tax will apply only if the payment takes the form of compensation; a dividend would be exempt from that tax. So, the low-tax option is for the employee-owner to work for free and to cause the firm to pay them a distribution instead. Of course, at least some portion of that payment would be nothing more than disguised compensation.

This very technique was used in two highly publicized cases involving

presidential candidates. In 2004, John Edwards was a U.S. senator from North Carolina and a top contender for the democratic nomination. However, before entering public office, he earned millions as a self-employed trial lawyer with a firm that bore his name. He organized the firm as an S corporation and paid himself a portion of the firm's earnings for his work practicing law. In 1997 alone, the firm's profits exceeded $26 million. However, between 1995 and 1999, he accepted an annual salary of $360,000. That allowed him to avoid approximately $600,000 in employment tax that he would have owed if he were a sole proprietor. He still had access to the rest of his earnings, he just received them in the form of a dividend instead of a salary.[1]

Both democrats and republicans have exploited this technique. During his 2012 campaign to be the republican presidential nominee, Newt Gingrich released his tax returns. They showed that he was the sole owner of two S corporations, both of which paid him compensation that was a fraction of what he earned through them for writing books and giving speeches. He paid employment tax on the amounts he received as compensation. However, he avoided $69,000 in employment tax on the amounts he received as a dividend.[2] Neither Gingrich nor Edwards had to pay back taxes, but their political images suffered. These two cases drew enough attention to this tax avoidance maneuver that it has become known as the Gingrich-Edwards Loophole.[3]

The government has been aware of this technique for reducing employment taxes for decades. In fact, a long line of reports issued by several agencies has examined it and considered ways policymakers could eliminate the opportunities for taxpayers to exploit it. Nothing has happened. In the meantime, the I.R.S. has been left with the unenviable job of policing taxpayers who engage in this form of evasion. Unfortunately, the agency has not demonstrated a capacity to attack it. When the I.R.S. audits S corporations, the agency does not scrutinize the amounts shareholders receive as compensation even when there is strong evidence



[1] Mark Koba, *How the Gingrich-Edwards Tax Loophole Works,* CNBC.com, Mar. 5, 2014, available at: https://www.cnbc.com/2014/03/05/cnbc-explains-the-gingrich-edwards-tax-loophole.html.

[2] *Id*.

[3] Some believe there is evidence that Donald Trump and Joe Biden have also exploited the same loophole. Richard Rubin, *Joe Biden Used Tax-Code Loophole Obama Tried to Plug*, WALL STREET JOURNAL, July 10, 2019, available at: https://www.wsj.com/articles/joe-biden-used-tax-code-loophole-obama-tried-to-plug-11562779300. Fred T. Goldberg Jr. & Michael Graetz, *Trump Probably Avoided His Medicare Taxes, Too*, NEW YORK TIMES, at A27, Nov. 3, 2016, available at: https://www.nytimes.com/2016/11/03/opinion/trump-probably-avoided-his-medicare-taxes-too.html.

that the firm paid the owner dividends as a substitute for the compensation they were entitled to receive.

It is unlikely that the I.R.S. will increase its scrutiny of the S corporation employment tax dodge no matter how frequently it audits S corporations. That's because the law governing this area is subjective and fact specific. S corporations have always been required to pay their owners "reasonable compensation" for their work. Taxpayers, courts and the I.R.S. alike have always had difficulty determining the amount that is "reasonable" in any given case. The process is so vague and burdensome that the time and effort it takes to enforce the law frequently is not worth the revenue the I.R.S. might collect. So, unless the I.R.S. defies this cost-benefit assessment, an increase in S corporation audits will not translate into greater enforcement of the rule requiring S corporations to pay owners reasonable compensation for their work.

That will have consequences beyond the fact that the government will forgo an opportunity to compel noncompliant taxpayers to pay the tax they owe. Having escaped government scrutiny once, the audited taxpayers will likely continue to utilize the S corporation employment tax dodge in future years, with a greater sense of confidence that they will not be called to account for their tax evasion. Second, as more audited taxpayers escape detection and penalty, other taxpayers will be inspired to engage in the same misconduct. So, what might be a sensible short-term business decision by the I.R.S. will have long-term costs in the form of lower taxpayer compliance and, more broadly, an erosion of public confidence in the integrity of the tax system.

It is a paradox that more I.R.S. audits of S corporations will lead more of them to evade employment tax. However, this tax policing paradox would not exist if Congress enacted an objective rule to replace the subjective "reasonable compensation" standard for determining a shareholder's compensation. The I.R.S. would be more likely to enforce such a rule, and taxpayers would be more likely to obey it.

This Article will proceed as follows. Part I will set the stage by describing the origins and evolution of the S corporation. Part II will describe the federal employment tax system and the way it applies to self-employed individuals who conduct their business through an S corporation. Part III will describe the legislative measures that caused the S corporation to grow in popularity while also becoming a vehicle for avoiding federal employment tax. Part IV will discuss a series of government studies critical of I.R.S. auditors for not adequately scrutinizing the compensation that S corporations pay their employee-owners, even when there are telltale signs that the firm is being used to evade federal employment tax. Part V will describe a model of tax enforcement and compliance that scholars rely on to

explain the connection between government efforts to police taxpayer compliance and the impact those efforts have on reducing tax evasion. The section will focus on empirical research showing that noncompliance with certain aspects of the law will increase if audits do not detect tax evasion when it occurs. Part VI explains how the I.R.S. would be more likely to police employment tax evasion by S corporations if Congress enacted an objective rule to replace the reasonable compensation requirement for determining the extent to which federal employment tax applies to the earnings of closely held S corporations.

## I. THE ORIGINS OF THE S CORPORATION

Congress created the S corporation in 1958 as a way to provide small business owners a measure of relief from the income tax at a time when such firms found it difficult to survive in an economy that was increasingly dominated by large commercial enterprises.[4] Although Congress expressly intended to provide relief from the income tax, the S corporation eventually became a vehicle for certain taxpayers to reduce their employment tax bills too.

Before the S corporation was added to the menu, there were only three options for operating a business: the sole proprietorship, the partnership, and the corporation. The first two are forms of doing business that arise organically when individuals engage in business activity. So, if an individual simply engages in a profit-making activity, the business takes the form of a sole proprietorship. If more than one individual engages in a profit-making activity, it automatically takes the form of a partnership. Today, we have become accustomed to the idea that a partnership can take several different forms, the limited partnership being one such form. Those variations existed back then. However, those variations introduced tradeoffs that prevented them from being suitable in many cases. Most importantly, an individual who was active in the business could not be a limited partner; they could only be a general partner. So, if all the participants were active in the firm, the undertaking would not qualify as a limited partnership. This meant that the participants would not have the benefit of limited liability, which would insulate them from the debts and obligations of the business.

The corporation was an alternative to these unincorporated ways of doing business. Its most distinguishing feature was that it offered limited liability to anyone who invested in the firm regardless of how actively they worked for the firm. However, this protection was not cost free because

[4] H-27.

corporate profits were taxed in a way that frequently made it less tax advantageous to operate in corporate form compared to a single- or multi-owner unincorporated business.

For tax purposes, the sole proprietorship and partnership were treated as extensions of the owners, so that the business itself was not a separate and distinct taxpaying entity. Instead, the owners of the business were taxed on their share of the profits derived by it. Thus, each owner paid tax on their share at the rate corresponding to their tax bracket. During the 1950's, individuals were taxed at progressive rates ranging from 20 percent to 91 percent.[5] The owners had to pay the tax, and it did not matter if they reinvested the earnings back in the business or withdrew the money to spend on their own personal consumption. This might present partners with particular difficulties if they had to pay a tax on amounts that they did not actually receive from the firm in years it simply retained the earnings for future use.

By contrast, the income tax system treated a corporation as a separate and distinct taxpaying entity. This meant that the firm had to pay tax on any profits it derived, while the owners had to pay tax on any (post corporate tax) profits that they received as a dividend. During the 1950's, corporations had to pay 30 percent in tax on the first $25,000 of profits and 52 percent in tax on the rest.[6] If the firm paid any dividends, the shareholders had to pay tax on those amounts at the rates that corresponded with their tax bracket, which, as just described, could reach 91 percent. The combination of the corporate tax and the dividend tax would frequently leave the owner with much less money than if the business was not incorporated. So, if someone chose to incorporate their business, that would be a more tax advantageous option only if two conditions were met. First, they were already in a tax bracket exceeding the effective tax rate that would apply at the corporate level. Second, they did not expect or intend to access the earnings of the business.[7] By one contemporary account, individuals had to have incomes no higher than $14,000 to be at a tax advantage by operating in corporate form, assuming they were willing to allow the firm to keep the earnings.[8] Of course, this second condition could



[5] ROBERT A. WILSON & DAVID E. JORDAN, PERSONAL EXEMPTIONS AND INDIVIDUAL INCOME TAX RATES, 1913-2002, STAT. OF INCOME BULL., Spring 2002, at 216, 219-20. The corporate tax might not be the only tax that would apply. The firm might have to pay the accumulated earnings tax if the IRS determined that the profits retained by the firm exceeded the amount it required to meet its future needs. The excess profits tax was another possibility. See H-27 at 9-10 and note 52.

[6] JACK TAYLOR, CORPORATION INCOME TAX BRACKETS AND RATES 1909-2002, STAT. OF INCOME BULL., Fall 2003.

[7] See also H-27 at 58 table II for an illustration.

[8] *See General Revenue Revision: Hearing Before the H. Comm. On Ways and Means,*

represent a considerable barrier in many instances. People don't go into business for the sake of it; they do so to make money that they can spend on personal consumption and other things that are unrelated to the business. So, suffice it to say that in the years preceding the decision by Congress to create the S corporation, each option on the menu of business forms came with a tradeoff. None of them offered what might be considered the two most important features: limited liability and a tax efficient way to access the firm's earnings.[9]

Indeed, tax considerations became a more salient part of business planning during World War II. That is when Congress expanded its use of the income tax on corporations and individuals to pay for the war and other aspects of government.[10] Not all firms could adjust to the elevated tax burden. The largest corporations could reduce the tax bite by retaining their profits and reinvesting the money in new factories and equipment. This accomplished two things. First, it prevented the shareholder tax on dividends from coming into play. Second, the amounts spent on new capital investments generated depreciation deductions that offset the firm's taxable profits going forward, driving down its future tax bills.[11] Larger companies also could finance the purchase of new assets by issuing common and preferred stock.[12] Smaller firms, however, usually did not have these options. They typically had to distribute earnings, which would trigger the shareholder tax on dividends, leaving less money for future investments. They also did not have the same access to the capital markets.[13] A contemporary analysis by two Harvard economists concluded that the combination of factors caused the tax system to foster the growth of firms that were already large to begin with.[14] A separate analysis by the same scholars showed that the tax system made it difficult for smaller firms to survive.[15]

While it was becoming more apparent that the tax system was affecting the ability of small firms to survive, the economy slipped into a recession. By 1958, business failures reached the highest rate since 1940, with small firms accounting for the lion's share of the total.[16] The conditions helped



---

83d Cong. 1363, 1368 (statement of F.N. Bard).

[9] H-27 at 11.

[10] H-27 at 11-12.

[11] H.R. Rep. No. 83-1002, at 2, 7-8 (1953).

[12] J. KEITH BUTTERS & JOHN LINTNER, EFFECTS OF FEDERAL TAXES ON GROWING ENTERPRISES 2-4 (1945)

[13] *Id*.

[14] *Id*.

[15] J. KEITH BUTTERS ET AL., EFFECTS OF TAXATION: CORPORATE MERGERS, 12-18 (1951)

[16] H-27 notes 287-291 and accompanying text.

elevate public debate over ways the government could address their financial hardship.[17] President Eisenhower expressed his commitment to alleviate the tax burden on small firms.[18] Similarly, members of Congress expressed a general desire to provide some form of relief for small businesses.[19] At the same time Wilbur Mills, who chaired the tax writing committee in the House of Representatives, set in motion a process that culminated in the enactment in 1958 of subchapter S of the Internal Revenue Code.[20] It gave certain corporations that had no more than 10 shareholders the option to be taxed as if they were partnerships.[21] So, individuals could enjoy limited liability without exposing themselves to the two layers tax on corporate profits. Nearly 20 years later, the shareholder limited was increased to 15.[22] Today the limit is 100.[23] So, the option is now available to a far larger number of firms, including businesses that some might not consider small.[24]

## II. FEDERAL EMPLOYMENT TAXES ON S CORPORATION OWNERS

The S corporation was designed to offer small businesses a chance to reduce their income tax liability. Congress did not consider how the federal employment taxes would come into play. The I.R.S. would address that question soon after subchapter S became part of the tax code. Then, as now, the federal employment tax system consisted of two separate legal regimes: the Federal Insurance Contribution Act (FICA) and the Self-Employment Contribution Act (SECA).[25] The IRS had to decide which of the two applied to S corporations and how, and it concluded that FICA was the applicable legal regime.[26]

FICA is the original statute that Congress enacted in 1935 to fund the

[17] H-27 at 44.

[18] 104 Cong. Rec. 331 (1958).

[19] H-27 notes 298-299 and accompanying text.

[20] H-27 at 46-50. Subchapter S does not represent the first time that Congress gave business firms the chance to choose how their profits would be taxed. In 1954, Congress enacted legislation that permitted a partnership to be taxed as if it were a corporation. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 1361, 68A Stat. 3, 350 (1954). As originally introduced the measure would have also permitted small corporations to be taxed like partnerships. H.R. Rep. No. 83-2543, at 72 (1954) (Conf. Rep.). Congress repealed this option in 1957 after Treasury failed to issue regulations to implement it. S. Rep. No. 85-1237 (1958).

[21] Technical Amendments Act of 1958, Publ. L. No. 85-866, § 64, 72 Stat. 1606, 1650.

[22] Tax Reform Act of 1976, Pub. L. No. 94-455, § 902(a), 90 Stat. 1520, 1608.

[23] I.R.C. § 1361(b)(1)(A).

[24] See generally the discussion of what counts as a small business in H-27 at 6-9.

[25] *See* I.R.C. §§ 3101 et seq. (FICA) and 1401 et seq. (SECA).

[26] Rev. Rul. 59-221, 1959-1 C.B. 225.

social security program. It generally covers anyone who works as an employee.[27] Congress enacted SECA later when it wanted to extend social security coverage to certain self-employed individuals.[28] By 1965, the system covered the entire class of self-employed persons, including sole proprietors and general partners in partnerships.[29] SECA was intended to impose a tax on amounts received for one's labor.[30] The SECA tax base is referred to as net earnings from self-employment (NESE).[31] In the case of a sole proprietor, NESE consists of all the profits derived by the business, other than certain items of passive income.[32] For partners in partnerships, NESE has historically consisted of the partner's share of partnership income and any amounts the partner receives as a "guaranteed payment" for the use of capital or the performance of services.[33] However, ever since 1974, that rule has only applied to general partners. For limited partners, NESE only consists of "guaranteed payments" that the partner receives for the use of capital or for the performance of services.[34]

On one level, FICA and SECA look the same. They both impose tax at the same rate. However, on a deeper level, they are dissimilar in some key respects. They define the tax base in different ways. Those differences probably did not mean very much when the I.R.S. was deciding how to proceed because it was operating in a tax environment that was very different from the one that exists today. In those early years, there was no risk that someone might use the S corporation to reduce their employment

[27] A-15 at 70-72. When first enacted, the Social Security system did not even cover all wage earning workers. A-15 at 70. By 1950, the system was expanded to include farm workers. Social Security Act Amendments of 1950, Pub. L. No. 81-734, 64 Stat. 477, 494-95.

[28] Social Security Act Amendments of 1950, Pub. L. No. 734, 64 Stat. 477.

[29] Social Security Amendments of 1965, Pub. L. No. 89-97, 79 Stat. 286, 380-81.

[30] *See* S. Rep. No. 81-1669 (1950). This report accompanied House Report 6000, the Social Security Act Amendments of 1950, Pub. L. No. 734, which first imposed the self-employment tax.

[31] I.R.C. § 1402(a).

[32] I.R.C. § 1402(a)(1)-(3). Passive items include things like rentals from real estate, corporate dividends, interest, and gains from the sale of capital assets.

[33] I.R.C. § 1402(a).

[34] Treas. Reg. 1.1402(a)-1(b) (as amended in 1974). The regulation predates a 1977 amendment that redefined what counts as self-employment income to a partner. Social Security Amendments of 1977, Pub. L. No. 95-216, § 313(b), 91 Stat. 1509 (current version at I.R.C. § 1402(a)(13). (This paragraph was originally added as paragraph 12. However, Pub. L. No. 98-21, § 124(c)(2), 97 Stat. 65 (1983), redesignated paragraph 12 as paragraph 13. The change only affected what counts as self-employment income to a limited partner. The legislative history does not elaborate on the intended scope of the change. *See* H.R. REP. NO. 8-702, at 85 91977). Thus, it appears that general partners remain subject to employment tax on guaranteed payments received both for services performed and for the use of capital.

tax bill. Quite the opposite.

In the 1950's, the benefits available through the Social Security program consisted solely of old age and survivor benefits.[35] Disability insurance coverage was added in 1956 to the basic program, giving rise to what we now refer to as OASDI (old age, survivors' and disability insurance).[36] The separate Medicare component was added in 1966. Throughout the 1950's the benefits were generally thought to be well worth the tax, which was imposed at a relatively low rate, especially when compared to the rates in effect today. That gave people an incentive to earn money that would enable them to qualify for the program's benefits. In 1951, when the employment tax consisted solely of OAS benefits, the total tax was three percent, split between the employer and the employee. After disability insurance was added in 1956, the combined rate was 4.5 percent. Even after Medicare took effect after 1965, the combined rate for all programs was 8.4 percent.

So, when the I.R.S. had to decide whether shareholders in S corporations would be treated as employees under FICA or self-employed under SECA, there was no reason to be concerned about taxpayers using this new business form as a vehicle to evade employment tax. In fact, the contrary was true; people were more than happy to do so.

Today, both FICA and SECA still impose two separate taxes, but the rates are much higher. The first is a 12.4 percent tax earmarked to finance the social security program.[37] The second is a 2.9 percent hospital insurance tax to fund the Medicare program.[38] There is a limit on the amounts that are subject to the social security tax. Known as the contribution and benefit base, it is fixed at $176,100 for 2025. Any amounts above that limit are exempt from the tax. The contribution and benefit base is adjusted each year to reflect increases in the average wages of the U.S. economy.[39]

For decades, the Medicare tax base was capped at the same level as the one that applied to the OASDI component of the tax. However, today the Medicare tax is imposed on an individual's entire employment tax base.[40] In addition, starting in 2013, in order to help pay for Obamacare, an additional 0.9 percent Medicare surtax has also applied to the extent the



---

[35] The cash benefit retirement program was the original benefit. Survivors' benefits were added in 1939.

[36] Social Security Amendments of 1956, Pub. L. No. 84-880, 70 Stat. 807.

[37] I.R.C. § 1401(a) (SECA). In the case of FICA, the employer and employee each pay half the tax. I.R.C. §§ 3101(a), 3111(a).

[38] I.R.C. § 1401(b)(1) (SECA). In the case of FICA, the employer and employee each pay half the tax. I.R.C. §§ 3101(b)(1), 3111(b).

[39] 42 U.S.C. § 430.

[40] *See* I.R.C. §§ 1401(b)(2)(1) (SECA), 3101(b)(1) (FICA).

taxpayer's income exceeds certain thresholds.[41] For a married couple filing a joint return, the threshold is $250,000; for unmarried individuals, it is $200,000; for married individuals filing a separate return, it is $125,000.[42]

When it determined in 1959 that the FICA rules would apply to the owners of S corporations, the IRS could have concluded that the business profits allocated to an S corporation shareholder resembled the business profits earned by a sole proprietor or a partner in a partnership because all three instances where the tax code treats the business as an extension of its owner and not as a separate and distinct taxpaying unit. Instead, the agency determined that the firm was just like any other corporation, where employment tax only applies to amounts paid to employees as compensation for their services. Thus, when an individual works for a corporation that they wholly own, they are treated as an employee whose employment tax bill depends on what they choose to pay themselves.[43]

The ruling might seem incongruous with the way the income tax rules applied to an S corporation. However, the I.R.S. may have had no choice in the matter. When the self-employment tax was enacted, the S corporation did not exist, so the tax base could not be defined by reference to amounts earned through such a business. Furthermore, when subchapter S was adopted, a shareholder's allocation of the firm's earnings (their pro rata share) was treated as a dividend.[44] The SECA statute expressly states that net earnings from self-employment do not include dividends.[45]

Subchapter S was later revised to modify the tax character of an S corporation's pro rata share. Today, that item is no longer regarded as a dividend. Instead, the individual items of S corporation taxable income flow through to the shareholders, retaining their character in the hands of the shareholder.[46] This made a shareholder's pro rata share virtually identical to a partner's distributive share, which is the term used to refer to their allocation of the firm's income. However, Congress never updated the self-employment tax statute to establish parity in the way the law applies to the two situations. Thus, today the statute does not define net earnings from self-employment to include an S corporation shareholder' pro rata share, while it expressly includes a partner's distributive share of partnership income as such.[47]

Until 1990 the cap on the employment tax base applied to both the

[41] I.R.C. §§ 1401(b)(2)(A) (SECA), 3101(b)(2) (FICA).
[42] I.R.C. §§ 1401(b)(2)(A) (SECA), 3101(b)(2) (FICA).
[43] *See* I.R.C. §§ 3101(a), 3111(a).
[44] I.R.C. § 1373(b) (1958).
[45] I.R.C. § 1402(a)(2).
[46] I.R.C. § 1366(b).
[47] I.R.C. § 1402(a).

OASDI and the Medicare components of the tax, effectively resulting in a ceiling on every aspect of the tax. While that was the case, people were more than happy to pay the tax because they perceived the Social Security benefits to be a good value for what they cost in tax. This general opinion is reflected in the efforts that taxpayers took to pay the tax, and the government's efforts to deny them that privilege. Until the late 1970s investment partnerships would actively promote themselves as a way for limited partners to qualify for Social Security benefits because the rules allowed their passive earnings from the partnership to count as part of the SECA tax base.[48] That was inconsistent with the program's purpose because a person's eligibility was supposed to be connected to their history of earning money by working, not merely collecting returns on an investment. To preserve the connection to work, the government adopted rules to limit the ability of individuals who earned passive returns as limited partners in investment partnerships from converting their passive income into active business income for SECA purposes.[49]

Meanwhile, the I.R.S. declared in 1974 that S corporations had a duty to pay reasonable compensation to any shareholder who performs services for the firm.[50] Known as Revenue Ruling 74-44, it invokes a provision of the tax code that permits taxpayers to claim a business deduction for salaries and other compensation only to the extent the amount is reasonable for the services rendered.[51]

The reasonable compensation requirement has inspired a less than coherent body of law that attempts to offer guidance about what is reasonable. However, these decisions have generally provided more heat than light. The I.R.S. drew from three seminal cases to provide some guidance to taxpayers.[52] The guidance takes the form of a fact sheet that declares at the outset that there is no bright line rule to determine what constitutes "reasonable compensation" to a shareholder employee of an S corporation. The fact sheet goes on to list the following nine factors that

[48] I.R.C. § 1402(a). Individuals in closely held C corporations and S corporations had reasons, other than qualifying for benefits, to treat amounts as part of the SECA tax base once they maxed out on the FICA tax. Although the SECA tax would not apply, the amounts that counted at NESE would enable them to make deductible contributions to a retirement plan. It might also enable them to take tax deductions for amounts allocable to the earnings they could characterize as NESE. *See* A-15 at 83. Taxpayers who took these positions were frequently had to contend with the I.R.S., who would assert that the amounts they received were nothing more than wages from their firm. *Id*.

[49] I.R.C. § 1402(13).

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

[51] I.R.C. § 162(a)(1).

[52] *See* David E. Watson P.C. v. U.S., 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010); Herbert v. Comm'r, T.C. Summ. Op. 2012-124; Sean McClary Ltd, Inc. v. Comm'r, T.C. Summ. Op. 2013-62.

courts have used to address the question.[53]

- Training and experience
- Duties and responsibilities
- Time and effort devoted to the business
- Dividend history
- Payments to non-shareholder employees
- Timing and manner of paying bonuses to key people
- What comparable businesses pay for similar services
- Compensation agreements
- The use of a formula to determine compensation.

The reasonable compensation requirement proved to be so difficult to apply and administer that the Treasury Inspector General for Tax Administration recommended in 2005 that the I.R.S. reconsider its initial 1959 ruling that FICA would apply to determine the employment tax liability of S corporation owners.[54] The Inspector General's argued that when time the I.R.S. issued the ruling, the government did not anticipate that the vast majority of S corporations would be single owner firms, which function as little more than incorporated sole proprietors. However, conditions had changed over the course of time in ways that have caused S corporations to be more widely used to conduct business and more widely misused to evade employment tax. Those changes are summarized in the next section.

## III. TRENDS IN THE USE AND MISUSE OF S CORPORATIONS

The S corporation employment tax dodge would not represent much of a threat to the integrity of the employment tax system if few businesses operated as S corporations or if relatively few people were in a position to use them to reduce their employment tax bills. However, that is not the case. Aside from sole proprietors, S corporations have grown to represent the largest number of business tax returns filed each year. Nearly all of these firms are wholly owned or nearly so. And they have been paying their owners an increasingly smaller share of their earnings as compensation for their work.

### *A. The S Corporation Gains an Income Tax Advantage*

It took several years before the S corporation gained the popularity that it enjoys today. This occurred largely because changes in the law made it a

[53] *See* I.R.S. Fact Sheet, FS-2008-25 (August 2008).
[54] A-27.

tax advantageous way to operate a business compared to the available alternatives. Initially, the tax advantage was limited to the opportunities it offered to reduce the income tax on business profits. That was consistent with the legislative intent behind subchapter S. However, S corporations ultimately evolved into a vehicle to reduce employment tax liability, too. All of this happened as a result of legislative developments that radically changed the tax landscape.

The S corporation sector did not experience an appreciable change in its level of use until after 1986. That is when the Tax Reduction of 1986 reversed the relationship between the top individual rate and the top corporate rate.[55] After a one-year transition, the maximum statutory rates were set at 28 percent for individuals and 34 percent for corporations. The rates were previously set at 50 percent for individuals and 46 percent for corporations. In addition, the legislation repealed something called the *General Utilities* doctrine, which permitted a traditional C corporation to distribute appreciated property to its owners without having to pay tax on the gain that was built into the asset.[56] This stood in contrast to the way that operating profits have always been treated; the firm pays tax on the income as earned, while the owners also pay tax when the firm distributes the earnings as dividends.[57] The *General Utilities* doctrine offered shareholders a way to tap into the value of their firm in a way that only triggered the shareholder tax, not the corporate tax. The repeal of *General Utilities* eliminated this tax advantage and made it more costly for owners to operate as a C corporation. Both the repeal of *General Utilities* and the inversion of the individual and corporate tax rates made it more tax advantageous to operate a business as an S corporation.[58] Partnerships enjoyed the same tax advantage.

The changes contained in the 1986 Tax Act were pivotal. As Figure 1 shows, before 1986, taxpayers utilized the S corporation less frequently than both the C corporation and the partnership to conduct business. After 1986, however, the growth of S corporations outpaced the growth of C corporations and partnerships. In addition, the earnings derived through S corporations began to account for a growing share of the earnings derived through all business entities.[59] Later pieces of tax legislation would add fuel to this trend.

---

[55] Pub. L. 99-514.

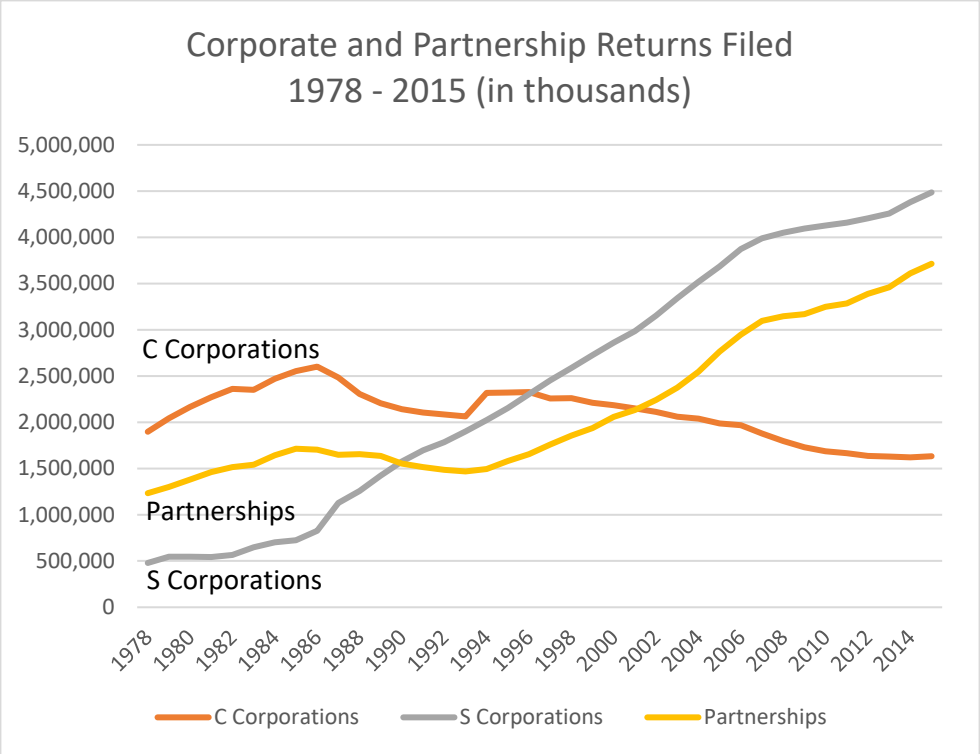
[56] General Utilities Corp. v. Helvering, 296 U.S. 200 (1935).

[57] I.R.C. §§ 11 (corporate profits), 61(a)(7) (dividends).

[58] However, one could not avoid the new tax on the distribution of appreciated property by simply converting a C corporation to an S corporation. Under the legislation, if the firm held appreciated property at the time of the conversion, the exit tax would apply to any distribution that occurred within the next ten years.

[59] F-28 at 12 fig. 3.

Figure 1




Source: Internal Revenue Service, Statisics of Income, Table 1, available at https://www.irs.gov/statistics/soi-tax-stats-integrated-business-data

The S corporation became available to more businesses and to larger businesses after 1996 when the provisions of the Small Business Job Protection Act took effect. That measure increased the number of shareholders that an S corporation could have, raising the limit from 35 to 75, while also allowing certain tax-exempt organizations and trusts to own shares in an S corporation. In addition, the legislation allowed banks that did not use the reserve method of accounting to elect S corporation status. In subsequent years, S corporations continued to account for a growing share of the total net income derived through business firms.[60] By 1997 the number of S corporation tax returns exceeded the number of returns filed by partnerships and C corporations.

During the presidency of George W. Bush, Congress twice (2001 and 2003) reduced the statutory tax rates on ordinary income, long-term capital gains and qualified dividends.[61] Later legislation enacted in 2004 lifted the

[60] F-28 at 12, fig. 3.

[61] Economic Growth and Tax Relief Reconciliation Act of 2001 and Jobs and Growth

cap on the number of shareholders an S corporation was allowed to have, increasing it from 75 to 100.[62] Scholars have not established a causal connection between the legislation and taxpayer behavior.[63] Still, the S corporation sector continued to grow. Between tax years 2000 and 2006, between 78,000 and 97,000 of existing C corporations converted to S status, representing 23 percent to 31 percent of new S corporations in each of those years.[64]

The elimination of the corporate tax was only one aspect of the income tax savings that could be realized through an S corporation.[65] It also allowed offered owners the chance to use any losses generated by the firm to offset income on their individual income tax returns.[66] This feature appears to have had value to a considerable number of business owners. During the six-year period spanning 2001 through 2006, 61 percent of the S corporations that reported losses in 2003 also reported losses in at least four other years during that window of time. In addition, over half of the firms generated losses in four or more consecutive years.[67] If those firms operated as conventional C corporations, those losses would only be available for the firm to utilize in future years to offset business income. Because the firms were S corporations, the owners could utilize the losses from the business to offset the income they derived from other sources.[68] When you consider the income tax advantages, combined with the liability protection, it is easy to see why S corporations now outnumber partnerships and C corporations.[69]



---

Tax Relief Reconciliation Act of 2003.

[62] Small Business Job Protection Act of 2004. The legislation also permitted up to six generations of one family to count as one shareholder.

[63] F-28 at 19.

[64] C-55 at 4.

[65] C-55 at 8.

[66] C-55 at 7.

[67] C-55 at 7.

[68] A study of S corporation owners from 2001 through 2017 determined that such taxpayers utilize 68 percent of the firm's losses immediately to offset other income from other sources. They utilize 87 percent of firm losses in 5 years. However, the present value of the tax savings is less than the tax that would be owed if the loss were taxable income instead. Only 15 percent of this asymmetry is the product of the time value of money. The rest of the asymmetry is produced by the progressive rate structure. Deductible losses have the potential to push taxpayers into lower brackets, which causes a loss to translate into lower tax savings, while income has the potential to push taxpayers into higher brackets, which causes the income to translate into a higher tax bill. G-89 at 343-44.

[69] C-55 at 9.

### *B. The S Corporation Become a Tool to Evade Employment Tax*

As the S corporation gained an income tax advantage, certain other legislative changes helped increase its value as a vehicle to evade federal employment tax. As already indicated, taxpayers had an incentive to pay employment tax because they wanted to fall within the scope of the employment tax system so that they would qualify for Social Security benefits, which were believed to be more generous than the taxes required to qualify for them.[70] The program remained a good value even after Medicare took effect after 1965, which brought the combined tax for all programs to 8.4 percent.[71] However, several factors reversed that relationship over the course of time. First, a series of rate increases was enacted into law as part of the Social Security Amendments of 1977, which caused the rate to reach 15.3 percent in 1990. Meanwhile, a portion of the Social Security benefit itself became taxable to high income individuals in 1984.[72] The rate increases for the basic Social Security benefits made the program less of a value because an individual's retirement and disability benefits are not a function of what they pay in tax. Rather, it's a function of their earnings record.[73] So, the higher tax payments did not translate into higher benefits.

Even though the combined changes made through 1984 may have reduced the incentive to pay employment tax, any incentive was virtually eliminated after 1993. That is when Congress removed the cap on the tax base for the Medicare component of the tax, which effectively removed any limit on what a taxpayer might have to pay.[74] The increased cost for the

---

[70] *Supra* note 48 and accompanying text.

[71] *See* A-15, at 74 note 41. These figures reflect the statutory rates under FICA. The rates were lower for SECA. An adjustment was necessary to account for the fact that an individual subject to FICA would face a tax burden that was lower than the statutory rate because the employer was entitled to deduct its share of the tax. The downward adjustments to the SECA statutory rates were intended to equalize the after-tax burden across FICA and SECA. *See* ROBERT J. MYERS, SOCIAL SECURITY 285-87 (4th ed. 1993). Over the course of time, a variety of mechanisms have been employed to achieve parity in the tax burden. *See* A-15 at 74-76.

[72] Social Security Amendments of 1983, Pub. L. No. 98-21, § 121(a) (1983).

[73] I.R.C. § 3121(a)(1); Social Security Act, 42 U.S.C. § 413(a)(2)(A). Thus, if an employer fails to pay its share of FICA taxes, that does not affect the employee's eligibility for benefits. They are still credited with the earnings they received from the employer. There is no provision that would justify reducing benefits or denying coverage on the grounds that taxes were not paid. *See* Social Security Act, 42 U.S.C. §§ 401, 411, 414.

[74] Revenue Reconciliation Act of 1993. Before the cap was eliminated, under the Omnibus Budget Reconciliation Act of 1990 set the earning sharply above the cap that was in effect for the OASDI tax. Starting in 1991, the Medicare earnings cap was $125,000 while the OASDI earnings cap was $53,400.

Medicare component did not come with additional benefits because eligibility for the program depends on the amount of time worked, not the amount of tax paid. In most cases, an individual qualifies for Medicare once they have worked ten years in covered employment.[75]

So, taxpayers no longer considered the benefits that are available through the employment tax system to be the value they used to be. In fact, there is evidence that that high income individuals shifted income from 1994 to 1993 to avoid the higher Medicare taxes that were scheduled to take effect.[76] There is also evidence that taxpayers in the position to disguise compensation as S corporation profit shares did so.[77] One study was conducted by a pair of I.R.S. district offices that examined S corporation returns for the 1995 tax year. The researchers wanted to quantify the extent to which S corporations were responding to the new incentive to underpay owners for their work.[78] They concluded that as much as $284 million in employment tax might have been underreported for that tax year by S corporations that substituted distributions for the amounts they would have otherwise paid as compensation.[79] Simply put, the changes to the Social Security system affected an individual's long-term opinion about the value of contributing to the system, and the data bears that out.

The evolving incentives to minimize employment tax is reflected in other data sets. An analysis by the Treasury's Office of Tax Analysis (OTA) detected an unmistakable trend in the composition of income reported by S corporation owners. These individuals have the power to determine whether the earnings derived by their firms are paid out to them as compensation for their work or as distributions.[80] Whatever is not paid out as compensation will appear on the owner's tax returns as their allocation of the firm's profits.[81] The combination of the two comprise the total business income derived by the firm. In addition to that, the firm might earn certain forms of passive income, like rents, capital gains, interest and dividends. The owner will be taxed on their share of these items, too.



[75] Social Security Act, 42 U.S.C. §§ 1395i, 1395t. The health insurance benefits were added in 1964.

[76] H-36 at 947, 949.

[77] H-36 at 949.

[78] B-14 at 2. The study was conducted by the Kansas-Missouri and District Offices of Research and Analysis.

[79] B-14 at 2.

[80] The compensation paid to owners could be reflected in three different places on the returns filed by an S corporation: compensation of officers, wages and salaries, or possibly as labor costs of goods sold. However, government economists have determined that officer compensation is a reliable proxy for the wages paid to S corporation owners, no matter how they are reported. F-28 at 9-11.

[81] The S corporation also separately reports rents and portfolio income, such as capital gains, interest and dividends.

However, as a practical matter, it is difficult for an owner to convert such income into compensation. So, when analyzing the extent to which S corporation shareholders are disguising business profits as compensation, it is helpful to consider these items separately from the firm's active business income. Active business income, together with the passive items, constitute the total net income of the firm.

The OTA researchers determined that in 1980, officer compensation accounted for approximately 80 percent of the total net income that S corporation owners derived through their firms.[82] By 2013, it accounted for 35 percent.[83] The downward trend was not a smooth one. Instead, there are inflection points that correspond to the legislative changes just described. For example, by 1991, five years after the 1986 Act, the aggregate amount of total net income and officer compensation reported by all S corporations had grown sharply. That is a logical reflection of the growing popularity of S corporations. However, there is little evidence that taxpayers were utilizing the S corporation to disguise labor income as business profits. This is apparent from the fact that the aggregate amount of officer compensation reported on all returns filed by S corporations was still over twice as large as aggregate profit shares; officer compensation also exceeded total net income by almost half.[84] Indeed, the aggregate amount of officer compensation paid by S corporations exceeded the aggregate amount of total net income as well as the aggregate amount of profit shares through 1993.[85]

However, that began to change going forward. The growth in total net income outpaced the growth in officer compensation after 1991. The shift coincided with changes to the Medicare Tax base. Prior to that time, the tax base for both the OASDI and the Medicare portions of the employment tax were the same. However, starting in 1991, the OASDI cap was 53,400, while the Medicare cap was $125,000.[86] Starting in 1994, the cap for the Medicare component was eliminated entirely.[87] The changes altered the calculus and increased the tax incentive for S corporation owners to disguise wages as profit shares. From 1994 through 2003, S corporation officer compensation was roughly equal to profit shares, accounting for a significantly lower share of the total compared to the prior period when compensation was twice as large as profit shares.[88] During that same



[82] F-28 at 16, fig. 6.
[83] F-28 at 16, fig. 6.
[84] F-28 at 17.
[85] F-28 at 13.
[86] Omnibus Budget Reconciliation Act of 1990.
[87] Omnibus Budget Reconciliation Act of 1993.
[88] F-28 at 13 and 14, fig. 4. Compare F-28 at 17.

period, officer compensation was approximately 77 percent of aggregate total net income.[89]

In 2010, the Affordable Care Act introduced another reason for S corporation owners to disguise compensation as profit shares. The legislation included a new 0.9 percent Medicare surtax on the employment earnings of individuals whose incomes exceed a certain threshold. For single filers, the threshold was $200,000; for married taxpayers filing a joint return, the threshold was $250,000. In addition, the same group of taxpayers became subject to a new 3.8 percent tax on most investment income. It was designed to mimic the Medicare taxes that applied to income from work. Both changes took effect in 2013. However, neither tax applied to the profit shares of S corporations.[90] This meant that if a taxpayer could substitute a distribution for compensation, they could avoid paying even more tax.

The incentive to disguise compensation as profit shares was strengthened even further by the American Tax Relief Act of 2013. It permanently extended the Bush tax cuts while raising the taxes on high income individuals. The top rate increased from 35 percent to 39.6 percent; the top rate on capital gains and qualified dividends increased from 15 percent to 20 percent. In combination, the American Tax Relief Act and the Affordable Care Act increased the tax on S corporation business profits by 3 percentage points, while compensation and other income was subject to tax at an additional 7 percentage points.[91] The growing differential in tax merely made it even more advantageous to structure payouts from an S corporation as dividends instead of as compensation. As was the case following the 1993 tax increases on wages, researchers found evidence that greater numbers of S corporation owners started reducing the compensation they received from their firms while increasing the amount they received in the form of profit shares.[92]

Up to now, the discussion has focused on how certain legislative changes have created an incentive for closely held S corporations to pay their owners a dividend as a substitute for any compensation they may have earned for their work. However, taxpayers and their advisors have devised other techniques that employ an S corporation for reducing their tax liabilities. One prominent example involves combining the S corporation with a general partnership. The basic design involves operating the business through a partnership. Ordinarily, any general partner in such an entity would be subject to SECA taxes on all the active business income

[89] F-28 at 13.
[90] Health Care and Education Reconciliation Act of 2010.
[91] F-28 at 20; H-36 at 952.
[92] H-36 at 957.

allocated to them. However, if the partner forms an S corporation to hold their interest in the partnership, the partner acquires the power to control their employment tax bill just like any S corporation owner would: by minimizing what they get paid for their work.[93] So the S corporation is not only being used to compromise the integrity of the FICA tax system, it's also being used to compromise the integrity of its SECA tax counterpart.

### *C. Patterns of Employment Tax Noncompliance*

#### 1. Ownership Patterns

The opportunity to reduce employment tax is not available to every S corporation shareholder. It is certainly available to shareholders who own all the stock in the company. Putting aside the legal rules about reasonable compensation, such individuals have unrestricted power to dictate whether they will be paid for their work and how much. The situation is more complicated when (1) the firm has more than one shareholder, and (2) there is a disparity in the level of work that each of them performs for the company. Consider the case of an S corporation that has two shareholders; one works for the firm, while the other does not. If the firm reduces or eliminates the wages paid to the employee-shareholder, that reduction will not translate into a dollar for dollar increase in the distribution that the employee-shareholder will receive. Instead, the reduction in wage expense will lead to a consummate rise in business profits that will have to be shared equally by the two owners.[94] These lopsided outcomes will occur whenever there is a disparity in the amount of work performed by the owners of a multi-owner firm. Therefore, firms that have only owner present the greatest risk. In order for the risk to be high in other cases, the employee-owner of a multi-owner firm would have to own a majority of the stock.

Single-owner firms dominate the S corporation sector. In tax year 2000, 78.9 percent of all S corporations were either fully owned by a single individual or more than 50 percent owned by one individual.[95] This means that in nearly 80 percent of the cases, one person had effective control over the manner in which to access the earnings of the firm: as a salary or as a dividend. By 2012, 90 percent of S corporations had only one or two



[93] C-55 at 34 (describing this technique). See also H-36 note 32 and accompanying text for yet another business structure that an individual can use to minimize employment tax.

[94] There are other secondary effects that must be considered. A reduction in wages will increase (1) any purchase price formulas that are based on earnings and any (2) bonus formulas that are based on earnings. Lower wages will also reduce the contribution base for the firm's qualified plans. H-19 at 43.

[95] H-24 at 1 and

shareholders, while 98 percent had five or fewer.[96] The figures a comparable for future years.[97]

2. Compensation Patterns

The available data provide ample reason to be concerned that single-owner firms are taking full advantage of their power to minimize the amount of compensation they pay the owner. In 2001, single shareholder firms paid out less than 42 percent of their profits in the form of salaries. That compares to just over 47 percent in 1994.[98] So, the compensation levels trended downward, leaving one to speculate why that might be the case.

It is entirely possible that the owners were not devoting as much time working for their wholly owned firms as they used to. It is also possible that, on average, they concluded that the work they did for their wholly owned firms did not add as much value to the business as it formerly did. Another possibility is that individual owners are collectively disguising more of their compensation as profit shares to avoid employment tax.

This last possibility may be the most likely explanation, especially when a firm makes substantial profits and pays the owner nothing as compensation. In fact, the government could identify 36,000 single-owner S corporation that paid no compensation to their owners in tax year 2000 even though each firm reported over $100,000 in operating profits that year.[99] This translated into a grand total of $13.2 billion of profits that were not subject to federal employment tax. Had each company operated as a sole proprietorship, the entire amount would have been subject to the tax.

It's one thing for the government to identify the cases that might be worthy of additional scrutiny. It's another thing for the government to compel each of these taxpayers to justify the amounts they report on their tax returns. However, that's easier said than done. Part of the problem is that whenever the government needs to scrutinize the level of compensation, it can only do so on a case-by-case basis. Because it is impossible for the government to individually examine every company, many S corporation owners have escaped scrutiny and may have simply concluded that it is worth the risk to work for free and play the audit lottery.[100]

The Treasury Inspector General for Tax Administration has explained

[96] F-28 at 6 (citing unpublished data from Statistics of Information).
[97] H-24 at 6 note 7.
[98] H-24 at 2 and 6 fig.
[99] H-24 at 2, and 4.
[100] H-24 at 2.

that taxpayer compliance with the reasonable compensation requirement is difficult because the outcomes depend on difficult factual determinations that must be made.[101] The Chief of Staff of the Joint Committee on Taxation echoed this observation, noting that enforcement of the reasonable compensation requirement is difficult because it involves factual determinations on a case-by-case basis.[102]

Another government study raised similar concerns about whether S corporations are fulfilling their obligation to pay reasonable compensation to their employee-owners. In a National Research Program Study of a random sample of 4,815 S corporation returns from tax years 2003 and 2004, the I.R.S. found that approximately 13 percent of S corporations misstated officer compensation.[103] Of the firms making this error, 93 percent understated the amount, while 7 percent overstated it.[104] The figures would suggest that 887,000 S corporation returns filed over the two-year period reflected this error.[105]

Noncompliance was not uniform across all S corporations. At the high end, 15 percent of firms with only one shareholder failed to pay adequate compensation to the officer, 10 percent of firms with two to three shareholders failed to do so, 4 percent of firms with four or more shareholders failed to do so.[106] This would be consistent with the relative freedom that single shareholder firms exercise in setting shareholder salaries irrespective of the amount of work the owner performs.

The median amount of misreported shareholder compensation was $20,127.[107] No other misreported amount identified in the study was this large. In fact, the second-highest median misreported amount was $7,411 for distributions, nearly $13,000 lower.[108] Underreported officer compensation was also over 20 percent as large as all other misreporting.[109] So it represents a significant figure in relative terms.

The noncompliance adds up into $23.6 billion in unpaid wages for those two years.[110] The figure consists of $24.6 billion in understated wages and



---

[101] H-24 at 3.

[102] F-61 at 3.

[103] C-55 at 25. This figure has a 95 percent confidence interval and is within +/-8 percentage points of the estimate itself. C-55 at 3.

[104] C-55 at 12, tbl. 3.

[105] C-55 at 11, tbl. 2. This figure has a 95 percent confidence interval and is within +/-16 percent of the reported value. C-55 at 3 and 11, tbl. 2 note c.

[106] C-55 at 13, tbl. 4.

[107] C-55 at 11, tbl. 2.

[108] C-55 at 11, tbl. 2.

[109] G-63.

[110] C-55 at 11, tbl. 2. This figure has a 95 percent confidence interval and is within +/-18 percent of the reported value.

$1 billion in overstated wages.[111] The net understatement in wages translates into around $3 billion lost employment tax revenue over the two years.[112] That would translate into an average of $3,382 in underpaid employment tax for each of the 887,000 returns that misstated officer compensation. The estimate is very rough because it does not reflect adjustments that would cause the true amount to be higher or lower. First, the calculation assumes that the entire amount of understated wages would be subject to tax, when it is possible that a portion of it is exempt because it exceeds the tax base for the OASDI component of the Social Security Tax. This would require a downward adjustment to the estimate. On the other hand, the figure does not reflect the 6.2 percent federal unemployment insurance tax on the first $7,000 in wages. That would require an upward adjustment to the estimate.[113]

The National Research Program study was undertaken in part because the government recognized that S corporations offer the potential for taxpayers to avoid employment. However, it would be wrong to assume that each case of misreporting represents a case of tax evasion. Nevertheless, the findings, when considered in conjunction with the other government statistics and studies, paint a picture that should raise concerns in the mind of tax administrators who are responsible for enforcing the law and raising levels of taxpayer compliance. The next section discusses a framework and a body of empirical studies that shed light on the essential elements of tax compliance and enforcement.

## IV. IRS AUDITS OF S CORPORATIONS

There is a compelling case for the government to be especially vigilant to police S corporations that are most likely being used as vehicles to avoid federal employment tax. S corporations are so popular that they outnumber both partnerships and C corporations. In addition, an overwhelming majority of S corporations are either wholly owned or controlled by one person. So, the problem is large, and the risk of employment tax evasion is high. However, the Treasury Department's own internal reviews have determined that I.R.S. auditors assigned to S corporations consistently fail to question the amount of compensation the firm pays shareholders. This is the case even when all the evidence suggests that the firm has paid the owner a distribution as a substitute for compensation.



[111] C-55 at 25 and note 46;
[112] C-55 at 25.
[113] C-55 at 25.

### *A. Study of 1998 Returns*

The Treasury Inspector General for Tax Administration (TIGTA), the department's internal watchdog, conducted a small-scale review of 84 S corporation audits performed by the I.R.S. between fiscal years 1999 and 2001.[114] The study of returns filed in 1998 focused solely on firms that paid less than $10,000 in officer compensation, while deriving ordinary income greater than $50,000, a group was believed to be at the highest risk of error.[115] The findings were stunning. The reviewed firms paid an average of $5,300 in wages, while making an average distribution of $349,323.[116] When the ratio of wages to distributions is this small, it is usually a telltale sign that some portion of the distribution is disguised compensation to the owners. Despite this fact, examiners did not always scrutinize officer compensation. The examiner left no comments in 22 percent of the cases, while an additional 9 percent of the case files contained insufficient workpapers for the researchers to analyze.[117] The latter subset of cases could have represented as much as $648,065 in unpaid employment tax.[118]

TIGTA acknowledged that it is difficult for an examiner to determine the amount that a shareholder should receive for services rendered to the firm.[119] One of the three offices included in the study attempted to overcome this difficulty by accessing a software program that could enable I.R.S. personnel to estimate an amount.[120] TIGTA formally recommended that I.R.S. management make it possible for examiners throughout the country to have access to the same software or some equivalent resource.[121]

TIGTA also expressly acknowledged another factor that makes it difficult for examiners to effectively and efficiently identify the cases that pose the greatest risk of employment tax evasion. They use a manual process to select which returns should be examined, the issues that should be examined, and how the examinations should be conducted. The process requires the examiner to individually inspect hundreds of S corporation tax returns for distributions and for loans to or from shareholders.[122] Although the agency maintains an electronic database that contains certain pieces of information for certain types of tax returns, that database does not include



---

[114] B-14 at 10-11.

[115] B-14 at 10.

[116] B-14 at 3.

[117] B-14 at 4.

[118] B-14 at 4. This assumes that the entire amount would be taxed and none of it would be exempt because of the cap on the tax base.

[119] B-14 at 4.

[120] B-14 at 4.

[121] B-14 at 5.

[122] B-14 at 5.

corporate distributions, the very piece of information that would allow an examiner to efficiently spot firms that might be making such payments as a form of disguised compensation.[123]

Under the circumstances, one can only expect so much from the I.R.S. personnel who must perform this task. In order to estimate the scope of the job, TIGTA noted that there were 2.6 million S corporation returns filed for tax year 1998. About 5 percent (126,559) reported less than $10,000 of officer compensation and over $50,000 in ordinary income, the two criteria it used to select the returns it included in its study. Because information about shareholder distributions and loans is not captured in any database, I.R.S. personnel would have to manually review all of those returns to effectively isolate the cases that merit examination for possible employment tax evasion. Understandably, TIGTA recommended that the I.R.S. start capturing corporate distributions in its database.[124]

TIGTA also determined that agency management does not collect the information it needs to consistently measure its S corporation compliance efforts. As a result, it is difficult for management to make informed decisions about how best to allocate resources and manage the process. Ordinarily, management relies on the Examination Operational Automation Database (EOAD) to monitor compliance performance. However, if an examination of an S corporation results in an adjustment to the amount of officer compensation, those adjustments typically appear on the firm's employment tax returns (Form 941), which EOAD does not capture. This information gap would be solved if the EOAD would capture officer compensation-related adjustments that are made to S corporation employment tax accounts.[125] That would be one way management could monitor just how frequently auditors are scrutinizing owner compensation.

Future government reports reflect these three themes. First, the agency could more efficiently select the returns that it audits. Second, auditors too frequently fail to scrutinize the compensation that S corporations pay their owners. Third, IRS management should improve its oversight of the work conducted by auditors.

It is customary for a report by TIGTA to include a response by I.R.S. management. However, no such response was received in time to be included in this report. So, there is no way to know whether agency management intended to implement any of the suggested reforms. Still, one visible development occurred two years later. The IRS issued a news release that identified several schemes used by taxpayers to avoid



[123] B-14 at 5-6. That particular database was called the Midwest Automated Compliance System (MACS).

[124] B-14 at 6.

[125] B-14 at 7.

employment tax, all of which resulted in adverse court rulings or convictions of taxpayers. The list included the practice of disguising S corporation officer compensation as corporate distributions.[126]

### *B. Study of 2006 to 2008 Returns*

The General Accountability Office (GAO) examined I.R.S. efforts to police noncompliance in the context of a larger report prepared at the request of the Senate Finance Committee to investigate a range of concerns related to taxpayer compliance in the S corporation arena. The GAO's assessment of audits closed in fiscal years 2006 to 2008 was also based on interviews with IRS officials, groups of IRS examiners and over 40 stakeholder representatives of nine industry and professional organizations, including small business associations, tax preparers groups and legal professionals.[127] Finally, the GAO collected information from the IRS on its enforcement and service programs.

The GAO report echoed the observation made in the earlier TIGTA report that the law for determining adequate compensation relies on a vague "facts and circumstances" analysis, which increases the burden for S corporations to determine the amount of compensation, while also creating opportunities for avoiding employment taxes.[128] The examiners they interviewed indicated that, because it is so difficult and time consuming to determine adequate compensation, they tend to only pursue the issue in the most egregious cases where shareholders receive little to no wages while receiving large distributions. Otherwise, the revenue payoff may not be worth the audit effort.[129]

The statistics would suggest that the effort is rarely worth the money. Between fiscal years 2006 through 2008, the agency examined over 16,000 S corporation returns, which represents less than 0.5 percent of S corporation returns filed.[130] Those examinations scrutinized the shareholder compensation issue in a very small minority of cases: 14.3 percent in 2006, 21.6 percent in 2007 and 15.6 percent in 2008.[131] These statistics are even more striking when you consider the fact that returns likely received a higher level of scrutiny because the study was part of the National Research



---

[126] I.R. 2004-47.

[127] C-55 at 2.

[128] C-55 at 26. This is consistent with an observation made by TIGTA in 2005. See G-6.

[129] C-55 at 27-28.

[130] C-55 at 17.

[131] C-55 at 28 tbl. 7 (GAO analysis of IRS Databook and IRS Examination Operational Automated Database (EAOD). As a general rule, the exams of any returns filed in one calendar year will be closed the following calendar year. C-55 at 8, note to tbl. 7.

Program (NRP).[132] Still, examiners did not offer much evidence of the work they undertook to evaluate the adequacy of compensation to shareholder employees. The GAO reviewed a random sample of the NRP files. The sample included 114 cases where the IRS determined that the shareholders compensation issue needed review. Only 24 of those files contained some evidence of an analysis, which generally consisted of using tools like monster.com, salary.com, and Bureau of Labor Statistics wag data to benchmark compensation levels.[133] Adjustments were made in ten of the cases that included some form of documentation of an analysis. However, examiners also made adjustments in 16 cases where the file contained no such documentation. Data reliability issues prevented the GAO from determining whether an examiner made a correction after scrutinizing an issue.[134] Officer compensation ranked among the top four issues examined.[135]

Overall, the GAO report provided a second indication that I.R.S. auditors frequently do not question the amount of compensation that an S corporation pays its owners. The report also expressed concerns that the agency's records may not contain the kind of information it would need to adequately oversee the audit function, including the selection of returns worthy of audit. At the same time, the GAO report acknowledges that there is no easy way to determine whether an S corporation has adequately compensated an owner. So, even if the agency incorporated all the efficiencies contemplated by the GAO, there is no way to avoid the tedious and fact specific inquiry that is required to determine the amount an S corporation owner should be paid for their work.

### *C. Study of 2016 to 2017 Returns*

A decade after the GAO report, TIGTA conducted its second review of I.R.S. coverage of officer compensation during audits. TIGTA's principal conclusion was not very different from the one it made the first time around: that the agency is not examining the issue of officer compensation at a rate that aligns with the risk of evasion. In this instance, TIGTA observed that approximately 30 percent of all S corporations have only one owner and also report no officer compensation. Treating these cases as having the highest risk of underpaying owners, TIGTA determined that 4.4 million S corporations fell into this category for tax years 2015 through

[132] C-55 at 29, note 55.
[133] C-55 at 29.
[134] C-55 at 18 note 34.
[135] C-55 at 17. The other three were gross receipts, purchases, and deductions other than shareholder compensation. C-55 at 17.

2017.[136] However, only 0.1 percent of S corporation returns had been scrutinized for that issue during a three-year lookback period.[137]

TIGTA examined returns that fell into two categories, those that were selected for a field exam, and those that were reviewed as part a special "workstream" within the Employment Tax program specifically focusing on the issue of officer compensation. The raw numbers speak for themselves. In the case of the Employment Tax workstream, the agency closed 12,362 exams during fiscal years 2016 through 2018.[138] In the case of field exams, the agency closed 17,059 exams from tax years 2015 through 2017. It examined the issue in 2,442 of the combined total, or 14 percent of the time.[139]

For its part, the IRS uses a different set of criteria to identify a high-risk return. In addition to asking (a) whether the firm has one owner and (b) does not report any officer compensation, the agency also asks whether the firm had at least $250,000 in gross receipts.[140] However, even in this subset of cases, the agency had no records showing that the issue of officer compensation was either selected for scrutiny or otherwise examined in 44.3 percent of the 3,172 examinations that were closed during a four-year window.[141]

TIGTA's earlier review from 1998 was critical of the labor-intensive process the I.R.S. had used to select a return for audit. It appears the process for selecting returns for field exams continues to rely on a huge element of human judgment. There are two steps in the process. First, a

---

[136] G-5 at 5.

[137] G-5 at 5. That scrutiny could have occurred in two contexts. It could have occurred in the context of field examinations of the firm's Form 1120-S. Or it could have occurred through a "workstream" that focuses on the issue of officer compensation within the Employment Tax program. In the case of field exams, agency personnel selected the issue for scrutiny on 14 percent of the Forms 1120-S from tax years 2015 through 2017 that were classified and reported (2,442 of the 17,059 filed). G-5 at 5. In the case of the employment tax workstream, the agency closed 12,362 exams during fiscal years 2016 through 2018. G-5 at 3.

[138] G-5 at 3. The Specialty Examination unit of the Small Business/Self-Employed Division has something called a "workstream" devoted solely to reviewing officer compensation. In very general terms, the unit applies a set of criteria to identify the S corporations that it will scrutinize on this issue. Although the unit analyzes the income tax returns of S corporations to select exam worthy cases, a firm's employment tax returns are the actual subject of the exam. G-2 at 2. An S corporation uses a Form 1120-S to report its income; it files a Form 941 to report its employment tax.

[139] G-5 at 5.

[140] G-5 at 5. Elsewhere, the report indicates that the IRS designates a Form 1120-S has a "strong return for the officer compensation issue" when (a) the firm has one owner, (b) does not report any officer compensation, and (c) has over $100,000 in profits. G-5 at 6-7.

[141] G-5 at 5. The analysis consisted of 3,172 closed examinations from fiscal year 2016 through fiscal year 2019.

computer driven process uses mathematical formulas to calculate and assign a score to returns that are eligible for an examination.[142] Next, from this pool of exam-eligible returns, IRS personnel individually select returns that will actually undergo a field exam. The IRS calls this the classification process. It consists of an individual examiner reviewing the line items on the return and applying professional judgment and experience to identify the returns that will be audited and the specific issues to scrutinize.[143] Among other things, examiners are directed to select returns where the potential tax change is sufficient to justify the work.[144] So, a field examination is not conducted solely on the basis of a computer-generated score. Instead, the return has also been reviewed by a trained examiner who has determined that there are sufficient issues worthy of actual scrutiny in the field. The issue of officer compensation was selected for scrutiny in 2,846 field exams of tax returns for tax years 2015 through 2017, which represents about 14 percent of the audit worthy returns.[145]

In its defense, IRS management cautioned TIGTA not to assume that the agency overlooked a valid audit issue just because the agency's records do not indicate that the issue was scrutinized.[146] Instead, according to management, a deeper inquiry will sometimes disclose that the shareholder paid employment tax even when the return shows zero officer compensation. For example, in a judgmental sample of 20 high risk cases whose files contained no notation that the officer compensation issue was scrutinized, there were six instances (30 percent) where the S corporation actually issued a W-2 wage statement to a shareholder who reported the wages on their personal income tax return.[147] In cases such as these, the shareholder's payment might be reflected in other items on the firm's return, such as salaries and wages, or the cost of labor incorporated into the



[142] G-5 at 4. The IRS calls this the Discriminant Function (DIF) scoring process. The score that a return receives reflects its audit potential. E-32 at 3. The IRS completed a National Research Program study of S corporations in fiscal year 2008 and subsequently developed a new DIF formula for selecting S corporation returns using new compliance data. E-32 at 8.

[143] G-5 at 4 and 8. E-32 at 9.

[144] E-32 at 9.

[145] G-5 at 5. This represents 2,442 of the 17,059 S corporation examinations that were classified and reported in the agency's "compliance data environment."

[146] TIGTA specifically used records contained in something called the Examination Operational Automation Database, or EOAD. It tracks the results of every exam on an issue-by-issue basis. G-5 at 5, note 15. IRM § 4.10.16.1. ¶ (1) (01-02-2013). Something called a Standard Audit Index Number (SAIN) is associated with specific issues. In the case of officer compensation, the SAIN is 512. G-5 at 6.

[147] G-5 at 6. A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population. E-32 at 7 note 3.

cost of goods sold.[148]

One should resist the temptation to infer too much from the sample of returns. First, a judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.[149] Second, the results seem at odds with a comprehensive study conducted in 2016 by the Office of Tax Analysis. Using data from tax years 2001 through 2013, they determined that 40 percent of S corporations issued no W-2s to its owners. In 75 percent of those cases (30 percent of the entire population), the firm did not issue a W-2 to anyone and also did not report any labor expense anywhere on the return, whether as officer compensation, wages and salaries, or labor costs of goods sold. In the balance of the cases, the firm reported some form of labor expense and issued a W-2 to individuals other than shareholders.[150] Conversely, in 51 percent of the cases, the firm reported labor costs somewhere on the Form 1120-S and also issued W-2s to shareholders.[151] The OTA researchers also found that of the total compensation paid in any form to shareholders over the 13 year period, 89 percent of it took the form of officer compensation.[152] This led them to conclude that the amount of officer compensation reported on a form is a "strong candidate to proxy owner's wages."[153] Therefore, unless there is some reason to believe that shareholder wages would take a form other than officer compensation in a high risk case, the judgmental sample seems to obscure realities instead of shedding light on the situation.

However, even if you take the results of the judgmental study at face value (which you should not), you are still left with the fact that 70 percent of the high-risk cases that were not scrutinized for the issue should have been. If the judgmental sample reflected the overall population of cases, it would suggest that the IRS overlooked a valid audit issue over 30 percent of the time when it examined a return.[154]

Even if you doubt the wisdom of assuming that officer compensation is the only way an S corporation will report a payment to a shareholder for services, there is another reason IRS management advised TIGTA to read the data with caution. Human error will affect the accuracy of the agency's



[148] G-5 at 6. See also F-28 at 6.

[149] E-32 at 7 note 3.

[150] F-28 at 8 and 9, fig. 1.

[151] F-28 at 8 and 9, fig. 1.

[152] F-28 at 9 and 10, fig. 2.

[153] F-28 at 9.

[154] The agency had no records showing that the issue of officer compensation was either selected for scrutiny or otherwise examined in 44.3 percent of the 3,172 examinations that were closed during a four-year window. Seventy percent of 44.3 percent is 31 percent. A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population. E-32 at 7 note 3.

records of examinations because those records are created manually by individual examiners.[155] In fact, of the 20 selected high risk cases whose files contained no notation that the officer compensation issue was scrutinized, there was evidence that the examiner, in fact, examined the issue in certain instances and also proposed adjustments in some of them.[156] This was the case even though IRS examiners are required to make a record of any issue examined, even if the review results in no adjustment to the return.[157]

Looking beyond the problems in interpreting the data, TIGTA tried to offer an idea of the foregone revenue. In this context, it focused on a subset of returns that the IRS did not select for a field exam where (a) the firm had only one owner, (b) the firm reported no officer compensation, and (c) the firm reported profits greater than $100,000.[158] Of all the S corporation returns received between processing years 2016 through 2018, 266,095 of them met this description.[159] Collectively, these firms reported $108 billion in profits and $69 billion in shareholder distributions.[160] TIGTA estimated that $25 billion of those distributions likely represented disguised compensation that would have triggered approximately $3.3 billion in FICA tax.[161]

TIGTA had three formal recommendations for the agency.[162] First, it advised the IRS to evaluate the risk of noncompliance and to update its examination plan so that it reflects the overall risk. IRS management roundly rejected this idea, asserting that its examination plan adequately addresses the issue. TIGTA's recommendation appears to have referred to both the field exams and the employment tax workstream. However, IRS management offered a response that only addressed field exams, indicating that it believed that examiners were classifying returns for officer compensation (14 percent of all returns examined) at a rate that was "commensurate with the compliance risk."[163] It based its conclusion on the 2016 OTA study which, according to IRS management, determined that less

[155] See IRM § 4.10.16.1 ¶ (3) (admonishing examiners to properly enter data because there is no subsequent review process to correct errors).

[156] G-5 at 6. The report redacted the actual number of files that fell into this category.

[157] IRM § 4.10.16.1.1 ¶ (2) (04-26-2011). See also G-5 at 5, note 15.

[158] It's unclear why TIGTA chose to focus on firms whose profits exceeded $100,000 when the IRS classifies a return as "high risk" when the firm has at least $250,000 in gross receipts. See G-5 at 5.

[159] G-5 at 6. This represents an exponential growth over time. In tax year 2000, there were only 36,000 cases that fit this description. A-27 at 12.

[160] G-5 at 6.

[161] G-5 at 6.

[162] The recommendations were specifically directed at the Commissioner for the Small Business/Self-Employed Division.

[163] G-5 at 9.

than 9 percent of S corporations did not issue a form W-2 to its shareholders.[164]

Management's response is puzzling. First, that is not what the OTA study found. It found that less than 9 percent of S corporations issued W-2s to shareholders and other employees, while simultaneously reporting labor costs. The study determined that an additional 10 percent of the firms reported labor costs while issuing no W-2s to its shareholders.[165] More importantly, a full 30 percent of the firms reported no labor costs and issued no W-2s. One would think that the more relevant statistic from this study is the combined 40 percent of firms that issued no W-2s to shareholders while also reporting labor costs.

Putting that aside, elsewhere in the OTA report, the authors call attention to the fact that wages to shareholders have been accounting for smaller and smaller share of the firm's total income over time.[166] In 1980, officer compensation accounted for 80 percent of the total. By 2013, it stood closer to 35 percent.[167] That would suggest that the risk of employment tax evasion has increased over time. Management's suggestion that it is only necessary to scrutinize 14 percent of the returns for this issue seems to disregard this data point. Aside from that, it is curious that IRS management would rely on the OTA study to determine whether its examination efforts are adequately targeted. The study's authors were attempting to measure the amount of income derived by S corporation shareholders that took the form of wages or compensation as opposed to business profits.[168]

TIGTA's second recommendation was for IRS management to consider using a threshold and specific criteria as part of classification guidance to promote greater consistency and efficiency.[169] Here again, IRS management rejected the idea that it should reevaluate its current approach. Instead, it doubled down on the current process that relies on individual examiners who apply their professional judgment to determine whether the issue merits scrutiny in any specific case. In this regard, management pointed to the training that examiners receive both in the classroom and on the job to identify instances where compensation is inadequate.[170]



---

[164] G-5 at 9. See F-28.

[165] F-28 at 2.

[166] F-28 at 16.

[167] F-28 at 16 figure 6.

[168] Curiously, TIGTA did not point out any of the concerns described in this paragraph or the preceding one. Instead, TIGTA simply asserted that management should not rely on the data from the study because it was based on 2013 data. G-5 at 9.

[169] G-5 at 9.

[170] G-5 at 9. Aside from making recommendations to the approaches for examining returns, TIGTA also offered a recommendation for improving the process of developing

It is difficult to accept management's position that I.R.S. auditors are scrutinizing with sufficient frequency the amount of compensation that S corporations pay their owners. It simply does not square with the weight of the evidence to the contrary. In fact, the response comes across as a feeble attempt to justify the agency's practice of limiting audits to issues where the potential tax collection is worth the effort.[171] One suspects that agency management simply did not think it would be wise to make such an admission in a way that might attract to much notice.

Whatever the case, at least it appears that the I.R.S. does not discriminate when it comes to overlooking the adequacy of an owner's compensation when it audits an S corporation's returns. Even when it audits the president, it does not question whether the owner's compensation is reasonable. President Biden and the first lady earned millions of dollars through two S corporations for a book and for making speeches. However, the firms paid them less than 6 percent of the earnings as compensation for their work. In 2019, a spokesperson for the Biden campaign defended the returns by claiming the amount that the firm paid to the couple was reasonable.[172] When the couple's returns were examined as part of the first routine audit of their taxes in 2020, the spokesperson for the Bidens indicated that the IRS agent discussed the finances of the S corporations going back to their inception in 2017 and "challenged nothing."[173] This seems remarkable in light of the fact that the returns contained all of the telltale signs that the amounts paid to the couple may have been substantially lower than what was "reasonable." However, if TIGTA's analysis is to be believed, at least it was not any different from the way the agency handles any other S corporation audits. The I.R.S. auditor will simply not question the amounts the firm paid an owner if they believe doing so would require too much work for the tax revenue at stake.

## V. THE ELEMENTS OF TAX COMPLIANCE AND ENFORCEMENT

The I.R.S.'s record of not using audits as an opportunity to scrutinize the amount of compensation that S corporations pay their owners calls into question how much of an impact the agency's practices are having on taxpayer compliance. Under the classic, deterrence model of tax evasion, a risk averse person will engage in some degree of tax evasion as long as they



---

proactive measures to mitigate noncompliance when returns that are filed appear to fall into a high-risk category. G-5 at 10-11.

[171] E-32 at 9.

[172] G-69.

[173] G-96.

can expect to derive positive value in doing so.[174] One key factor that affects someone's decision is the probability that their evasion will be penalized.[175] Thus, they will be less inclined to engage in evasion if there is an increase in the probability of detection or the penalty.[176] Accordingly, if the chances of being audited are high, evasion will decline.[177] The model is not strictly concerned with the actual risk of being detected. Instead, the taxpayer's perception of the risk is what matters most. Admittedly, those perceptions could be formed by the facts. This would be the case if tax authorities increase the resources they devote to audits, and taxpayers become aware of those efforts. Alternatively, tax authorities could simply strategically release information about their audit practices. That has the potential to affect taxpayer perceptions as much as an actual change in those practices.[178]

The model contemplates that a taxpayer's perceptions about the likelihood that evasion will be penalized can vary depending on the type of evasion in question. For example, the probability may be 100 percent in the case of employee compensation. Because employers are required to report the compensation they pay to employees, it is virtually certain that the I.R.S. will detect any instance where an employee simply does not report such earnings. On the other hand, the probability is much lower for self-employment income, which frequently is not reported to the I.R.S. by the party who made the payment. However, even for self-employment income, the model assumes that the probability of detection will increase with the magnitude of the evasion.[179]

The following sections discuss a number of empirical studies that help shed light on the principal factors that impact taxpayer compliance with the reasonable compensation requirement. The studies lead one to conclude that the reasonable compensation requirement is the kind of rule that is ripe for abuse, and that taxpayer noncompliance with the rule will accelerate if the I.R.S. audits more S corporations without scrutinizing payments to shareholders at greater rates.

1. Deterrence In General



[174] H-13 at 908. This model was formulated by Michael G. Allingham and Agnar Sandmo in *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323 (1972). They adapted to tax evasion a model of criminal behavior articulated by Gary S. Becker in *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

[175] H-13 at 907.

[176] H-13 at 908.

[177] H-13 at 908.

[178] H-13 at 908.

[179] H-13 at 908.

Taxpayers are deterred from engaging in tax evasion when they believe the risk of detection is high. One reliable way to make it easier for the government to identify (and discourage) certain forms of tax evasion is to require the people who make payments to file information reports with the I.R.S. When taxpayers know that an item is subject to information reporting it is very unlikely that they will omit or misstate the item on their tax return. Various studies of the tax gap underscore the key role that this form of deterrence plays in reducing tax evasion. When an item is subject to both tax withholding and substantial information reporting, the estimate of noncompliance is less than 1 percent.[180] By contrast when there is little or no information reporting by third parties, noncompliance exceeds 60 percent.[181]

Small businesses account for a major part of the income that is not subject to information reporting. The IRS estimates [in the 2016 Tax Gap report?] that 47 percent of underreporting by individuals comes from business income.[182] An earlier scholarly study estimated a lower, but still sizeable underreporting rate. It found that 35 percent of self-employment income is not reported.[183] By either measure, the amount of self-employment income that goes unreported is substantial. The magnitude of the difference also underscores the explanatory power of the deterrence model; the probability of detection and penalties is a key driver of tax evasion. Indeed, evasion "proliferates" when taxpayers believe that the risk of detection is low.[184]

2. The Special Risk of Self-Employed Persons

It is not unreasonable to believe that self-employed individuals would be less risk averse to all forms of uncertainty. That would include the risk of being detected and punished if they engage in a form of tax evasion. However, there is no empirical evidence that attempts test this theory or to measure the extent of any difference in the level of risk aversion that self-employed individuals might possess compared to other taxpayers.[185] However, there is some empirical evidence indicating that there is at least a correlation between self-employment and tax collections.

One scholar examined over 80 countries and plotted the fraction of

[180] H-13 at 916 (citing 2016 Tax Gap Report). [Must update with 2021 Tax Gap report.]

[181] H-13 at 916.

[182] H-13 at 916.

[183] H-13 at 917 (citing Naomi E. Feldman & Joel Slemrod, *Estimating Tax Noncompliance with Evidence from Unaudited Tax Returns*, 117 ECON. J. 327 (2007).

[184] H-13 at 916.

[185] H-13 at 940.

workers who were self-employed against the ratio of tax collections to gross domestic product. The study documented that countries with more self-employed people collect less tax.[186] This pattern is not universally true. There are two studies that establish that tax evasion is more sustainable when the taxpayer derives income from self-employment activities.[187] Still, the weight of the evidence points toward the need to be very cautious and vigilant when dealing with taxpayers who are self-employed.

Individuals who conduct business through S corporations are not usually treated as belonging to the ranks of the self-employed. That designation is generally reserved for sole proprietors. However, any difference between the two is more formal than real when the S corporation only has one owner. As a practical matter, single shareholder S corporations are little more than sole proprietors who enjoy both the advantage of limited liability and the power to control their employment tax bill. Therefore, any studies that correlate self-employed individuals with higher levels of noncompliance can offer insights to tax administrators who want to reduce the amount of employment tax evasion by individuals who conduct business through wholly owned S corporations. Simply put, this group of taxpayers represents an elevated risk. As such, they deserve an extra level of scrutiny by tax authorities.

3. Audits as a Deterrence Tool

Audits can have a measurable impact on the behavior of the specific persons who are audited. Audits also affect the perceptions of the general taxpaying public. However, the direction of the change is not unambiguous. Under the deterrence model, the question revolves around the impact that an audit has on the taxpayer's perceptions about their chances of being audited again. On the one hand, a taxpayer might be less inclined to comply in the years following an audit on the theory that the chances of getting audited a second time is low. On the other hand, a taxpayer might be more likely to comply (and less likely to evade) if they think that the tax authorities have gotten wise to an evasive practice.

Recent studies have shed some light on these questions. The results of a laboratory study published in 2022 concluded that tax audits do not have a positive effect on the post-audit compliance of the audited taxpayers in the



[186] Henrik Jacobsen Kleven, *How Can Scandinavians Tax So Much?*, 4 J. ECON. PERSPECTIVES 28 (2014).

[187] Wojciech Kopczuk and Joel Slemrod, *Putting Firms into Optimal Tax Theory*, 96 AM. ECON. REV. PAPERS AND PROCEEDINGS 130 (2006); Henrik Jacobsen Kleven, Claus Thustrup Kreiner & Emmanuel Saez, *Why Can Modern Governments Tax So Much? An Agency Model of Firms as Fiscal Intermediaries*, 83 ECONOMICA 219 (2016).

aggregate. Instead, the behavioral response of any specific taxpayer will depend on two factors. It primarily depends on whether the audit was effective in detecting noncompliance by the taxpayer. Taxpayers tend to increase their compliance when the audit detected all undeclared income but decreased their compliance afterwards when the audit failed to do so.[188] The researchers believed their observations suggested that ineffective tax audits stimulate risk-taking and that the response of taxpayers whose underreporting was not detected drives down the average level of post audit compliance that is observed in the aggregate.[189] This suggests that audits may do more harm than good in curbing specific forms of tax evasion if they do not detect it. The researchers also concluded that post-audit compliance is also affected by the taxpayer's prior reporting behavior. Relatively compliant taxpayers generally adjust their level of compliance in response to the effectiveness of an audit. By contrast, relatively noncompliant taxpayers appear to be more motivated by the expected value of the evasion gamble and do not alter their reporting behavior after going through an audit.[190] The message for tax administration is to ensure that audits are effective at identifying all forms of tax evasion. Otherwise, the audit may do more harm than good in the long run to deter noncompliance by the audited taxpayer.

The results of a separate study published in 2020 offer additional lessons for tax administrators. The research team examined operational audits that were conducted on a pool of self-employed taxpayers who underwent an audit after filing their 2007 returns. On an overall basis, operational tax audits induced taxpayers to increase the amount of income they reported by roughly 10 percent 1 year after the exam, and roughly 2 percent 3 years out.[191] However, the researchers observed substantial differences in results across taxpayers depending on whether the audit resulted in an additional assessment or not. If the audit resulted in an additional tax assessment, the taxpayer reported around 64 percent more income the year after the exam compared to the control group.[192] Meanwhile, if the audit did not result in an additional tax assessment, the taxpayer reported around 15 percent less income than their unaudited counterparts in the control group.[193] Moreover, these impacts endure over time. Audited taxpayers who received an additional assessment reported on average 44 percent more income three years out compared to their

[188] H-55 at 100.
[189] H-55 at 100.
[190] H-55 at .
[191] H-57 at 249.
[192] H-57 at 259.
[193] H-57 at 259-60.

unaudited counterparts.[194] Meanwhile, audited taxpayers who did not receive an additional assessment reported an average of 21 percent less than their unaudited counterparts.[195]

The authors believe that their findings have implications for the way that the Internal Revenue Service goes about conducting audits. First, because some audits do not result in an additional assessment, there would appear to be room for improving the efficiency of audits in two respects. First, the agency should improve its capacity to target potential noncompliant tax returns. Second, it should improve its ability to detect noncompliance on the tax returns that are selected for audit. Steps to address these two aspects of the audit function would appear to have the potential to improve deterrence among cheaters.[196]

The results of yet another study published in 2018 indicated that when taxpayers do change their behavior as a result of an audit, the changes appear to be significant but relatively short lived. In the three years following the audit, taxpayers who started reporting more income increased the amount of self-reported income by 7.51 percent compared to a control group of unaudited taxpayers. However, after five or six years out, these same taxpayers reported less self-employment income compared to the unaudited control group.[197] The validity of these findings is not beyond question. The subjects of the audit were informed that they were randomly selected for research purposes. It is possible that their responses to the audit might not be representative of the responses of taxpayers who are deliberately selected because they fit a certain risk profile, which is how the IRS ordinarily identifies taxpayers for an audit.[198]

4. The Role of Tax Advisors

If the taxpayer consults a tax advisor, the available evidence suggests that the tax advisor may encourage the client to take an aggressive position. A 1991 study based on data from a 1982 randomized audit study conducted by the I.R.S. found evidence that tax preparers discourage noncompliance when an issue is legally unambiguous. However, they actually encourage noncompliance when the issue is ambiguous.[199]



---

[194] H-57 at 260.

[195] H-57 at 260.

[196] H-57 at 262.

[197] Jason DeBacker, Bradley T. Heim, Anh Tran & Alexander Yuskavage, *Once Bitten, Twice Shy? The Lasting Impact of IRS Audits on Individual Tax Reporting*, 61 J. LAW AND ECON. 1 (2018).

[198] H-13 at 925.

[199] Steven Klepper, Mark Mazur & Daniel Nagin, *Expert Intermediaries and Legal Compliance: The Case of Tax Preparers*, 34 J. L. AND ECON. 205 (1991).

Because there is no objective way to determine how much compensation is reasonable, the study's findings should alarm members of the tax enforcement community. In fact, government officials have long expressed concerns about the "cottage industry" that has emerged to advise small business on the technique of using an S corporation to save on employment taxes.[200] The National Research Program of S corporation returns for 2003 and 2004 determined that 81 percent of the firms used a paid preparer.[201] If those preparers or other professionals are also advising the firms, their involvement would work against the interests of taxpayer compliance if the government is not scrutinizing owner compensation on a consistent basis. Quite simply, to compete for clients, the professionals in this cottage industry are under pressure to counsel taxpayers to take aggressive positions.[202]

A separate study published in 2018 also showed how so-called spillover effects occur among taxpayers who share a tax advisor. The researchers tested whether U.S. businesses who were at risk of being delinquent in making employment tax payments behaved any differently when they received a letter versus a visit from a revenue officer. Not surprisingly, a visit from a revenue officer had a substantially greater impact than a letter did. The study also identified a measurable increase in tax payments among firms that shared the same tax preparer with the firm that received an in-person visit compared to firms who shared a tax preparer with a business that only received a letter.[203] So, tax advisors can serve as a form of amplifier. But, the messages they relay to their clients may not necessarily help to elevate taxpayer compliance.

5. Taxpayer Networks

The taxpayer's personal networks represent another factor that may affect the overall level of taxpayer compliance with specific requirements. Networks can take any number of forms, including families, co-workers, tax preparers (discussed in the preceding paragraph), and the internet.[204] One study of Austrian taxpayers showed that if one member of a network is subject to a field inspection, compliance rates increased significantly among



[200] H-24 at 3.

[201] C-55 at 15.

[202] H-20 at 552, *citing* Richard J. Kovach, *Bright Lines, Facts and Circumstances Tests, and Complexity in Federal Taxation*, 46 SYRACUSE L. REV. 1287, 1306 (1996).

[203] William C. Boning, John Guyton, Ronald H. Hodge, II, Joel Slemrod & Ugo Troiano, *Heard It through the Grapevine: Direct and Network Effects of a Tax Enforcement Field Experiment*, NBER Working Paper 24305 (2018).

[204] H-13 at 938.

those who were not.[205] This is consistent with the general observation that audits will lead to higher rates of compliance among the general public, not merely with the taxpayer who was audited.

A separate Austrian study tested how persons within a taxpayer's network responded when they became aware of a form of tax evasion that was not detected. The researchers focused on whether an individual's work environment affected whether they would improperly claim a commuter tax allowance. The study found that individuals were more likely to improperly claim the allowance once they learned from their co-workers that overreporting would not be detected. At the same time, if an individual is in the habit of cheating, they do not change their behavior once they are exposed to an environment of compliance.[206] These two studies suggest that audits will positively affect compliance rates when they successfully detect taxpayer misconduct. However, the opposite will occur if audits fail to detect misconduct; noncompliance is likely to accelerate.

The U.S. employment tax study and the Austrian study discussed in the last paragraph have important lessons about the power of audits to increase taxpayer compliance. Audits have the potential to increase the compliance rates of more than just the S corporation that is the subject of a particular form of noncompliance. However, the reverse can also be true: audits that do not question a specific form of noncompliance have the potential to increase that form of noncompliance beyond the taxpayer subject to the audit. Thus, if an audit is not performed in a competent or comprehensive manner, it may do more harm than good. We can only speculate how far these spillover effects might extend beyond the networks of taxpayer who is audited or how quickly these effects might occur.[207] However, the mere existence of these negative spillover effects offers a cautionary tale to tax administrators. Audits of S corporations will not achieve their full potential to deter noncompliance unless the audits address all forms of noncompliance, or at least the most substantial ones.

A recent study involving multinational firms underscores the validity of this last observation. The study focused on an instance where the IRS had the power to assess taxes, penalties and interest under an objective rule, but failed to do so. The agency gained this power in 1986 when Congress amended Internal Revenue Code section 482 to require that intercompany transfers of valuable intangible property reflect the actual income generated



---

[205] Johannes Rincke & Christian Traxler, *Enforcement Spillovers*, 93 REV. ECON. AND STATISTICS 1224 (2011).

[206] Jörg Paetzold & Hannes Winner, *Taking the High Road? Compliance with Commuter Tax Allowances and the Role of Evasion Spillovers*, 143 J. Pub. Econ. 1 (2016).

[207] H-13 at 939-40

by the property after the transfer.[208] The rule replaced one that instructed taxpayers to use an arm's length standard to set the price for such transactions. That approach proved to be an invitation to abusive transactions as U.S. members of a multinational group would grossly undercharge a foreign group member for an intangible asset that would later generate profits that far exceed the arm's length price. The practice effectively allowed multinational groups to shift profits overseas where they would not be subject to U.S. tax.

The IRS implemented the statutory provision by issuing a regulation that required taxpayers to make periodic post-sale adjustments to the purchase price to reflect the actual income generated by the assets.[209] The authors of the study examined a series of six reports showing specific violations of the regulation; the IRS failed to enforce its own regulation in every instance.[210] The researchers estimate that the government could have collected approximately $1 trillion in additional revenue if it enforced the rule against all noncompliant taxpayers, including the six examined in the study.[211]

More importantly, the researchers determined that the professionals who advised the taxpayers are supporting and encouraging their noncompliance. This is apparent from the fact that there is no reference to uncertain tax positions in audited financial statements and SEC filings for the six taxpayers that they studied.[212] These advisors include law firms, accounting firms, independent auditors and other tax advisors who appear to have overlooked the potential tax exposure that the noncompliance creates. The authors note that if the IRS were to enforce its own regulation, all similarly situated taxpayers and their advisors would be on notice to increase the selling price for the property so that the U.S. members of the group would realize larger taxable profits from the transactions.[213]

## VI. A WAY FORWARD

It is unrealistic to expect the I.R.S. not to perform a cost-benefit analysis when deciding whether to scrutinize a specific form of potential taxpayer noncompliance. It is also hard to imagine that there are other pathways available to the agency to address S corporations whose owners receive

[208] JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, JCS-10-87, at 1016 (1987).
[209] Treas. Reg. 1.482-7.
[210] H-25 at 1298 note 7.
[211] H-25 at 1313.
[212] H-25 at 1313, 1321.
[213] H-25 at 1321.

compensation dressed up as distributions. In some cases, taxpayers have the option to secure a decision from the agency about how the tax law might apply to a transaction whose tax implications might be less than clear. However, the I.R.S. has a policy against issuing such private letter rulings when the taxpayer wants to know whether an amount of compensation is reasonable.[214] It is one of the many questions that the IRS will not rule on because of the fact specific nature of the inquiry.[215] Although there may be reasons to oppose a blanket ban on issuing private letter rulings in certain cases, the benefits would probably be very limited with questions that revolve around reasonable compensation. Advance rulings can be most valuable when the government wants to address a specific category of taxpayers whose members are not too numerous.[216] That does not describe the class of closely held S corporations. Also, a device like the private letter ruling will have most value when the taxpayers within the affected group are homogeneous enough such that they can be expected to have the same reaction to the policy.[217] That also does not describe the class of closely held S corporations. So, it seems sensible for the agency to observe a blanket policy not to provide advance rulings on the issue of reasonable compensation.

The absence of an administrative option for eliminating the tax policing paradox discussed in the Article forces us to consider a legislative option. The analysis begins by asking what the law is trying to accomplish. At bottom, the law is attempting to allocate the earnings of the business into two categories: the part that represents a return on the owner's labor, and the part that represents a return on any capital they have invested in the firm. The returns on labor are subject to employment tax, while any returns on capital are not.

Currently, the law attempts to achieve theoretical purity by asking taxpayers and the government to isolate the returns on labor in situations where it is impossible to disentangle those returns from the returns on capital. This problem is not unique to individuals who operate a business through an S corporation. The business income derived by sole proprietors also represents a return on both capital and labor. Yet, the law does not attempt to disentangle the two sources. Instead, it simply treats the entire amount as a return on labor by subjecting all the profits to employment tax.



---

[214] Rev. Proc. 2023-1 § 3.01(35).

[215] See Rev. Proc. 2023-1 § 6.02.

[216] H-20 at 553, *citing* Benjamin Alarie, Kalmen Datt, Adiran Sawyer & Greg Weeks, *Advance Tax Rulings in Perspective: A Theoretical and Comparative Analysis*, 20 N.Z. J. TAX'N L. & POL'Y, 362, 382 (2014)

[217] Yehonatan Givati, *Game Theory and the Structure of Administrative Law*, 81 U. CHI. L. REV. 481, 490-91 (2014).

The fact of the matter is that it is an exercise in futility to attempt to achieve theoretical purity in this area when the owner of a firm also works for the business. Under these circumstances, it is only sensible for policymakers to consider a second-best option. Indeed, the procedure for imposing employment tax on sole proprietors could be considered an example of a second-best option. It is imperfect, for sure. However, at the very least, it possesses two virtues that scholars have exalted. It eliminates the risk that individuals will manipulate how much income gets taxed.[218] It also operates with a great deal of efficiency.[219] However, there are other approaches that could possess these same two virtues. The scholarly literature on the design of legal rules might help identify other options.

Louis Kaplow's 1992 article "Rules versus Standards: An Economic Analysis," represents the seminal work of scholarship on this question. In that article, he attempted to identify the factors that influence the way that rules and standards should be designed. He also explored the circumstances when rules or standards are likely to be preferable. For purposes of his analysis, the only difference between rules and standards is that rules specify the content of the law before individuals act, while standards do not, making it necessary for courts to provide content afterwards.[220] In terms of cost, rules are more costly to promulgate than standards. Conversely, standards are more costly for legal advisors and enforcement authorities to apply because the content of the law must be determined afterwards.[221] This is what has been happening with the reasonable compensation requirement. It costs so much to apply it that the governmental body responsible for enforcing the rule has determined that it is not worth the effort. So, the rule frequently goes unenforced.

As a general proposition, Kaplow contends that rules should be preferred when the frequency of application in recurring fact scenarios is high.[222] He specifically cited the internal revenue code as an example.[223] When it comes to distinguishing between the income derived from labor and the income derived from capital, the situation occurs with a high frequency in the case of closely held business firms, whether they take the form of S corporations or not. However, there might be far less agreement on whether we are dealing with and area that involves recurring fact scenarios. The central bone of contention would be that, as a factual matter, labor and capital are likely to play very different roles in producing profits

[218] A-15 note 143.
[219] D-10 at 1630.
[220] B-25 at 560.
[221] B-25 at 563.
[222] B-25 at 563-64.
[223] B-25 at 564, 573.

across firms. This is where doctrinal purity must take a back seat to efficiency.[224] However, this would not be the first time that the tax code would be making this trade off.

The 2017 Tax Act included a provision that might serve as a framework for a legislative measure to isolate labor income for employment tax purposes. Known as the GILTI tax, this provision is designed to prevent companies from avoiding U.S. tax on income generated by foreign affiliates.[225] Although the acronym stands for Global Intangible Low Taxed Income, the tax does not require the foreign affiliate to own any intangible assets. Instead, the statute merely seeks to determine the profits that are subject to U.S. tax and the profits that are exempt from U.S. tax. Under the statute, the exempt portion is the amount attributable to a 10 percent return on the adjusted tax basis of the affiliate's investments in tangible business property.[226] All profits exceeding that amount are subject to U.S. tax.[227] As a practical matter, the 10 percent return is the statute's way of answering the following question: How much did the foreign affiliate's capital investments contribute to the firm's profits? The GILTI rules assume that the contribution is equal to 10 percent of the adjusted tax basis of such property.

The capital investments made by a foreign affiliate of a multinational enterprise are comparable to the capital investments that a self-employed individual might make in their business. The only difference is that the residual profits will represent something different in each context. For a multinational enterprise, the GILTI statute treats the amount as intangible income that is subject to U.S. tax. In the self-employment context, such residual profits will represent the business owner's labor income. For this reason, the GILTI rules might inform a set of reforms to determine the employment tax base for individuals who work for an S corporation that they also own. Such a reform might allow the employment tax to operate in a more consistent and principled way. Aside from that, the I.R.S. would be more likely to enforce such a rule, and taxpayers would be more likely to obey it.



[224] D-10 at 1630.
[225] I.R.C. § 951A.
[226] *Id*. at 951A(b)(2)(A).
[227] *Id*. at 951(b)(1).