S Corps and Partnerships: Beware of Failure-to-File Penalties

The S corporation is a popular business structure that's available only to privately held businesses. In fact, approximately 44 percent of small employer firms -- generally defined as companies with fewer than 500 employees -- have elected to operate as S corporations, according to the U.S. Small Business Administration's Office of Advocacy. (By comparison, only 22 percent of small employer firms operate as C corporations.)

Contemplating a Switch?

Many private businesses elect to operate as S corporations primarily to take advantage of the federal tax benefits. But not every business is eligible.

In order to make the switch your business must:

- Be a domestic corporation;
- Have only allowable shareholders:
    - May be individuals, certain trusts and estates, and
    - May not be partnerships, corporations or non-resident alien shareholders;
- Have no more than 100 shareholders;
- Have only one class of stock; and
- Not be an ineligible corporation, including certain financial institutions, insurance companies, and domestic international sales corporations.

All shareholders must consent to the S corp election by signing Form 2553, *Election by a Small Business Corporation*.

Another important consideration when electing S status is shareholder compensation. The IRS closely monitors how much S corporations pay shareholders who work for the company. Agents are on the lookout for S corporations that underpay shareholders to avoid paying employment taxes. A combination of low salaries and high distributions could become a red flag that elicits unwanted attention from the IRS.

To the extent that a shareholder's compensation doesn't reflect the fair market value of the services he or she provides, the IRS may reclassify a portion of earnings as unpaid wages and then the company will owe additional employment tax on the reclassified wages.

To ensure that you've considered all the pros and cons, always consult with your tax and legal advisers before making the switch from C to S corporation status.

The primary reasons for electing S status are (1) to retain the limited liability of a corporation and (2) to pass corporate income, losses, deductions and credit through to shareholders for federal tax purposes. In other words, S corporations generally avoid double taxation of corporate income. Instead, S corporation shareholders report the pass-through of these tax items on their personal tax returns and pay tax at their individual income tax rates.

However, if you operate a business as an S corporation, there's a relatively steep penalty for failure to file a timely federal return each year, using Form 1120S. A recent U.S. Tax Court decision illustrates the point. A parallel failure-to-file penalty applies to partnership returns that aren't filed on time using Form 1065. Here's what you need to know.

S Corp Failure-to-File Penalty

The penalty for failure to file a federal S corporation tax return on Form 1120S -- or failure to provide complete information on the return -- is $195 per shareholder per month. The penalty can be assessed for a maximum of 12 months.

For example, the monthly penalty for failing to file a calendar-year 2014 Form 1120S for an S corporation with three shareholders is $585 ($195 times 3). If the return remains unfiled for 12 months or more, the maximum penalty equals the monthly penalty multiplied by 12. So the maximum failure-to-file penalty for a three-owner S corporation would be $7,020 ($585 times 12).

Important Note: Many federal tax penalties are assessed based on the amount of tax owed. So these penalties cannot be assessed if the taxpayer doesn't have positive taxable income and a resulting tax bill. However, the S corporation failure-to-file penalty can be assessed whether the S corporation produces positive taxable income or not. Therefore, filing S corporation returns can't simply be ignored because no tax is owed.

Facts of the Recent Case

Babak Roshdieh was the sole shareholder of a California medical services S corporation, which was the taxpayer in this case. The corporation had a history of filing its federal income tax returns late. This case specifically involves the 2010 return, which was due on March 15, 2011. The corporate secretary claimed that he sent in a request for an extension to file the return by regular first-class mail. The IRS claimed that the extension request was never received.

According to a certified transcript, the Form 1120S for 2010 was received by the IRS via regular first-class mail on January 31, 2012. The IRS then assessed a $2,145 failure-to-file penalty based on the return being filed 11 months late ($195 times 11 equals $2,145).

After attempted negotiations -- during which an IRS offer to settle for less than the full amount of the penalty assessment was refused -- the case wound up in the U.S. Tax Court. At trial, the taxpayer claimed that a timely request for a six-month filing extension to September 15, 2011, had been filed for the 2010 federal tax return and that the 2010 return had been filed on October 15, 2011 (one month late). Therefore, the taxpayer claimed that only $195 was owed for the failure-to-file penalty. The IRS position was that no extension request was received and the 2010 return was not received until January 31, 2012.

The taxpayer's corporate secretary also claimed that he had filed extension requests for every corporate tax year from 2002 through 2013. But the secretary offered no evidence to support his claim. The IRS provided certified transcripts showing that it had received extension requests for only six of the 12 years. Finally, the taxpayer was unable to offer any proof that the 2010 return was filed on October 15, 2011, as claimed.

Tax Court Decision

Based on the available information, the Tax Court concluded that no request to extend the corporation's 2010 return had been received by the IRS and that the 2010 return wasn't received by the IRS until January 31, 2012. Therefore, the full penalty assessment was upheld. (*Babak Roshdieh M.D. Corp*., T.C. Summary Opinion 2014-113)

Same Thing Can Happen with Late-Filed Partnership Returns

Subject to limited exceptions, unincorporated businesses and investment ventures with two or more participants are treated as partnerships for federal income tax purposes. It doesn't matter if the venture isn't formally organized as a partnership under applicable state law. Ventures that are treated as partnerships for federal tax purposes must file annual federal returns using Form 1065. The potential penalty for failure to file a partnership return -- or failure to provide complete information on the return -- is also $195 per partner per month. The penalty can be assessed for a maximum of 12 months.

So the same failure-to-file penalty issue can potentially arise with partnerships. But the risk may be even higher in this scenario because business venture participants sometimes may not realize that they have created a partnership for tax purposes and that federal returns are due.

Bottom Line

S corporations and other business ventures with two or more participants that are treated as partnerships for tax purposes must file timely annual federal returns or potentially face steep failure-to-file penalties. These penalties can be assessed even though the S corporation or partnership in question doesn't produce positive taxable income. Whenever you become involved in a business or investment activity, consult with your tax adviser regarding necessary tax filings and professional tax preparation assistance.