

S corps. get IRS scrutiny

By **KEVIN KREUTZ**
Staff Writer

For two years now, prominent South Coast real estate developer, banker and philanthropist Michael Towbes has been writing 100 checks for \$10,000 each to nonprofit organizations.

The \$1 million in what Towbes calls "community dividends" comes from the earnings of Montecito Bank & Trust, the private bank where Towbes is the sole shareholder.

He's been distributing the gifts since 2003, when his bank made a seemingly simple change to its corporate structure. It switched from a traditional C corporation so a so-called subchapter S corporation, a move that halted the double-tax on its earnings and allowed millions to flow through to the bottom line.

S corporations allow businesses with 75 shareholders or fewer to pay a reasonable salary to its executives and let the rest of the income pass through untaxed to the owners. With many small businesses and wealthy owners, S corporations are popular in the Tri-Counties.

But, the Internal Revenue Service is going to give S corporations a closer look. On July 25, the agency said it will conduct a random audit of 5,000 S corporations to ensure, as IRS Commissioner Mark Everson stated in the release, "that corporations and high-income individuals are paying their fair share."

The agency is facing an annual \$300 billion tax gap, the difference between taxes collected and taxes owed the federal government. It has been charged with closing that gap by \$50 billion per year.

Auditing S corporations may prove bountiful. The IRS reports that in 2002, the most recent year for which the IRS has compiled such data, S corporations as a

whole reported \$185 billion in profits.

By 2002, S corporations accounted for 60 percent of all corporations in the United States, according to the IRS. There are now 3.5 million nationwide, and California ranks third, only behind Florida and New York, as having more S corporations than any other state.



David Rachford, CPA, Rachford & Co.

David Rachford, a certified public accountant based in Santa Barbara, said the large amount of small businesses and wealthy citizens in the region fits the profile of S corporation owners.

"It's usually very popular in professional services like law and accounting," Rachford said.

He regularly advises entrepreneurs to select the S corporation structure when starting a business. The advantage, Rachford said, is "not being overly taxed on success."

The size of the audit group, only 5,000,

makes the odds 1 in 620 that an S corporation will be audited in the upcoming study, Rachford said.

But "any time the IRS increases scrutiny, it means the taxpayer should be alert and make sure their affairs are in order," Rachford said.

"The IRS has to be more closely looking at these S corps," said IRS spokesman Victor Omelczenko. "They have quadrupled since 1984."

The IRS' National Research Program will oversee the audits, which will cover the 2003 and 2004 tax years. The IRS expects the audits to begin later this year.

Senior Tax Specialist Sharon Sanders, who works in the Los Angeles region and the Tri-Counties, said a number of factors will figure into the audits.

"The main reason is to make sure the S corporation as an entity is treated correctly," Sanders said. "Reasonable compensation is a very big issue for us."

It's sure to be the stickiest subject of the audit, Rachford said, because there's no hard and fast rule on what constitutes a reasonable payment.

That's particularly true for Towbes, who doesn't even take a salary from the bank.

"The main reason I did it was it enables me to make charitable donations," Towbes told the Business Times during a recent interview.

Net income before taxes for the first six months of 2005 was \$5.8 million at Montecito Bank. The bank would have earned much less, about \$3.4 million, as a C corporation.

For his part, the audits do not concern Towbes. He doubts the IRS will spend much time looking at banks, which are already so heavily regulated. "There are a lot of other corporations that don't have those kind of reviews," he said.