

Focus

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S Corporations -- Audit Triggers

S corporations remain “king of the entities” among those forms of doing business nationwide. Except for the unincorporated sole proprietorships, the S corporation is the most popular form of small business in the United States. In fact, over the past 15 years, the number of S corporations has quadrupled. That trend has not gone unnoticed by the IRS.

Combine the rising popularity of the S corporation with intense pressure put upon the IRS by Congressional leaders to close the “tax gap” (the difference between what is owed and what is collected) and the perfect storm for more IRS audits has developed. A recent report on the tax gap, which hovers at around \$300 billion annually, blames up to 80 percent of it on small businesses. IRS intelligence also bears out that result, with a particularly large group of abusive tax techniques concentrated among S corporations.

IRS Commissioner Mark W. Everson reported recently that audits of S corporations have increased over 20 percent during the past year. Everson said that the IRS has begun to place more emphasis on the growing area of flow-through entities, “a source of potential noncompliance.” Kevin Brown, the IRS Commissioner of the Small Business/Self-Employed (SB/SE) Division also pulled no punches recently when he commented that “some

troublesome areas exist in the area of S corporation tax compliance.”

Currently there are two new IRS audit initiatives against S corporations. First, the IRS is intensely auditing “a statistical sampling” of S corporations to gather data on what it should look for in auditing other S corporations. Nationwide, this audit blitz now includes 5,000 unlucky S corps. If you are selected, expect a fight on almost every



line of your return. Good records and supporting data will help in this area. Second, the IRS is attacking S corporation compensation practices. In particular, auditors’ eyebrows are being raised if salaries paid by an S corporation to its principal owner or owners look suspiciously low. This “troublesome

area,” as SB/SE Commissioner Brown calls it, involves a technique in which the S owner/employee draws a low salary to avoid employment taxes that ordinarily would be due on additional wages but would escape tax if passed through as dividends. Brown labeled this practice as “abusive” and warned that “IRS examiners are aware of the practice.” Not only are IRS examiners disallowing this technique but they reportedly are also assessing 20 percent accuracy-related penalties. A review of W-2 income and total distributions received by the S corporation owner-employee during the year may be in order for many businesses.

Early Withdrawals from Individual Retirement Accounts

You may withdraw money from an IRA at any time. However, the withdrawal will trigger income tax liability of the amount withdrawn (except for some Roth IRAs) and a 10 percent penalty tax unless there is an exception to this general rule. Funds in an IRA should be the last nest egg you touch unless the 10 percent penalty can be avoided.



10 percent penalty.

Withdrawals from traditional IRAs and Roth IRAs are taxed differently since the 10 percent penalty only applies to the portion of the distribution subject to income tax (except for amounts attributable to Roth conversions within five years):

- For a traditional IRA, distributions are treated as coming ratably from contributions and earnings. Only the portion of a distribution attributable to nondeductible contributions is not taxed, while the portion of the distribution attributable to deductible contributions is treated the same as earnings.
- For a Roth IRA, distributions are first deemed to be paid out of contributions, which are nondeductible (or already taxed in the case of a rollover situation). Therefore, substantial withdrawals may be made for any reason from Roth IRAs without tax or penalty.

The exceptions.

Several new exceptions to the 10 percent penalty have been created in recent years. Most of these exceptions apply to both traditional IRAs and to Roth IRAs. For example, the penalty tax does not apply to certain distributions from a traditional or Roth IRA for qualified first time home buyers.

The 10 percent penalty will not be assessed on an IRA distribution to the extent that any of the following exceptions apply:

- Qualified first-time home buyers can take up to up to \$10,000 from an IRA tax-free for acquisition costs and settlement costs as well as other eligible expenses (traditional or Roth IRA; also exempt from income in Roth IRA).
- The 10 percent penalty does not apply when you use the IRA distribution to pay for qualified higher education expenses (traditional or Roth IRA).
- Some unreimbursed medical expenses also are eligible for tax-free distributions (traditional or Roth IRA).
- Some unemployed individuals can withdraw funds from an IRA to pay medical insurance premiums (traditional or Roth IRA). Military reservists who are called to active duty may be eligible for penalty-free withdrawals.
- The 10 percent penalty also does not apply to distributions on the death or disability of the IRA owner.

The general rule of thumb on IRA

withdrawals is that a taxpayer should contribute in the first place only those funds that he or she will not touch under any circumstances. However, if emergencies arise, at least it will be up to you, rather than Uncle Sam, to make the decision on the trade off between keeping funds for retirement and using them for certain other important lifetime events.



Recordkeeping

- Common Requirements for Business Income

Record keeping is important so that your tax return can be properly prepared and so that claimed items can be backed up in the event of an audit. There are common records that are needed in connection with taxes on your business income. Also, the IRS released recent guidance on electronic storage of recording, including on the opportunities and pitfalls involved in electronic recordkeeping.

Keep records of all of your gross receipts. They are needed so that you can properly report gross income from the business activity and self-employment taxes owed on your net earnings. Self-employment taxes are equivalent to social security taxes paid by both an employee and the employer.

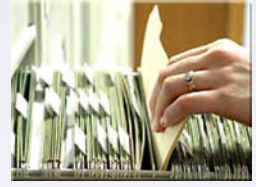
You must keep proper track of all expenses that are potentially deductible. To this end, keep track of compensation paid to employees and independent contractors, repairs, rents, taxes and licenses, bank charges, business insurance, utilities, postage and shipping charges, and travel and entertainment expenses, among other items.

On the subject of travel and entertainment expenses, there is some good news. Documentary evidence of business travel and entertainment expenses is not necessary for expenditures under \$75. The old threshold (pre-September 30, 1995) had been just \$25. For purposes of the \$75 rule, each separate payment is treated as a separate expenditure and you can treat a tip as a separate expenditure. Although you



no longer need documentary evidence for many travel and entertainment expenses under \$75, you still must comply with other recordkeeping requirements to substantiate deductions, such as keeping records of the time, place and date of the business travel, and business reason for the travel, etc. Also, you still need bills and receipts for any lodging expense regardless of its amount. Although the \$75 rule

has been around for over Twelve years, Congress has not given any indication that it will raise this amount for inflation anytime soon.



Keep permanent records of assets that you depreciate. Keep receipts of how much you paid for the property and records showing when you placed assets in service or changed them from personal to business use. Also, keep records of capital improvements.

If you use your car in business, whether you base your deductions on actual expenses or you use an IRS standard mileage rate, there are a number of records that you must keep. They include records of business miles and total miles, records showing when you started using your car in business and its basis, records of actual expenses if you do not use the standard mileage rate, and a number of other items regardless of which alternative you use.

Similarly, very specific and detailed recordkeeping is required when you use a portion of your home in your business. Records must show the part of the home that is used for business and that such use is exclusive. Records also are needed to show the depreciation and expenses for the business part of the home.

The IRS has issued a revenue procedure applicable to taxpayers who maintain books and records using an electronic storage system. The IRS defines an electronic storage system as a system that prepares, records, transfers, indexes, stores, retrieves and reproduces records by either imaging hardcopy records or transfers computerized books and records to an electronic storage medium. The IRS has issued guidelines to insure the integrity of the system and governing controls, inspections and quality assurance. Although the taxpayer may destroy paper records if it has a system within the IRS's guidelines, we caution that potential penalties may not apply if the taxpayer maintains its original books and records, perhaps at a remote, low overhead location.

Taking Money *from* C Corp

Your business may have reached the point of such success that you want to start taking more money out of it. The owner of a business run as a corporation can simply have the company declare a dividend, which would be payable to the owner and any other shareholders. However, this route bears a heavy tax cost. The company will have already been taxed on the earnings used to pay the dividend, and you will be taxed on its receipt. Fortunately, there are other ways of taking money out of a business at a much lower tax cost.

Some steps can be taken to produce immediate tax savings. Other efforts will reduce taxes down the road. Also, there may be opportunities to get business funds in the hands of family members at a lower tax cost than would result if the funds were paid directly to the owner.

Maximum savings per dollar can be realized when the business makes expenditures that benefit the owner, are deductible by the business and are not taxable to the owner. Lesser but still good savings can be realized for business expenditures that benefit the owner, are deductible by the company and are either taxed in a favorable manner to the owner or are tax-deferred. Some items that the business may legitimately deduct may be only par-

tially taxable to the owner or may not be subject to social security taxes. Many valuable fringe benefits fall into these categories and can produce substantial savings.

Even distributions or expenditures that are fully taxable to the owner may be better than dividends, if the company can deduct them. For example, a dividend paid by a C corporation is not deductible by it and is taxable to the shareholder. If that same amount could properly be paid out to the shareholder as compensation, it would still be taxable to the shareholder but at least the company would get a deduction.

Similarly, distributions that are not deductible by the company but that are taxable to the owner as capital gain usually are preferable to nondeductible distributions that are taxable to the owner as ordinary income.

Exactly what tax-favored ways may be used to take money out of a particular business depend on the exact nature of the business, its structure and other factors.



Like-Kind Exchanges

A like-kind exchange is an alternative to triggering capital gains by selling property. The sale of property causes you to recognize a gain. You must pay taxes on this gain. A like-kind exchange, on the other hand, allows you to avoid gain recognition through the exchange of qualifying, like-kind properties. The gain on the exchange of like-kind property is effectively deferred until you sell the property you receive. The IRS allows this tax-deferred transaction because it recognizes that since your



economic position remains the same (you have merely exchanged one property for another), you should not have to incur taxable gains. You will, however, have to recognize gain on any money or unlike property that you receive in the exchange.

Only certain property qualifies like-kind treatment. To qualify, both the property you give up and the property you receive must be held by you for investment or for productive use in your trade or business. Buildings, rental houses, land, trucks, and machinery are examples of property that may qualify.

2008 Planning - Casualty Losses

If your home or other property is damaged as a result of a fire, earthquake, flood, hurricane, vandalism or similar event, you may be able to take a deduction for the loss. To be deductible as a casualty loss, the property must be damaged, lost or destroyed by a sudden, unexpected or unusual event. Therefore, using the term “tax planning” when referring to a casualty loss may seem inappropriate. However, if you have suffered a loss, there are several tax issues that you need to consider, such as determining the year in which to take the



loss, the benefit of married individuals filing separately, valuation of the property, limitations and adjustments to the loss, and finally the tax consequences of any insurance reimbursements or recoveries.

A casualty loss is not allowed when the loss is gradual, such as insect damage to trees or water damage from a leaky roof. Therefore, damage or destruction resulting from progressive deterioration

of property, such as beachfront erosion, would not qualify as



a casualty loss. Loss of property through theft is deductible, but merely misplacing property is not.

The amount of a deduction is generally determined by the difference in the fair market value of the property before and after the loss, or by the cost of the necessary repairs to restore the property to its original condition. However, the amount of a loss cannot exceed your basis. Even with the destruction of a home or building, the loss is actually not a total loss since the land retains its value. The amount of the loss is further reduced by any amounts covered by your insurance company, *regardless of whether or not you file a claim*. After the loss is determined and the insurance reimbursement is subtracted, the loss deduction is further reduced by \$100 for each casualty, any casualty gains, and 10 percent of your adjusted gross income.

Like-kind exchanges provide a valuable tax planning opportunity if:

- You wish to avoid recognizing taxable gain on the sale of property that you will replace with like-kind property;
- You wish to diversify your real estate portfolio (for instance) without tax consequence by acquiring different types of properties with the exchange proceeds;
- You wish to participate in a very useful estate planning technique (continued like-kind exchanges allow you to permanently avoid recognition of gain); or
- You would generate an alternative minimum tax liability upon recognition of a large capital gain in a situation where the gain would not otherwise be taxed.

(The like-kind exchange shelters other income from the alternative minimum tax.)