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Tax News 3rd Quarter 2006

The Office has relocated

Our new physical address is:

**2775 Trotters Walk Trail
Snellville, GA 30078**

Our mailing address is still:

**P.O. Box 390428
Snellville, GA 30039**

Our new phone number is:

(770) 978-9565

Our fax number is still the same:

(404) 795-0467

What else is new?

I have been short handed since the end of June, primarily due to circumstances beyond my control. As a result I have been stretched a bit thin and not as accessible to clients as I would like. I also have to take a certain number of continuing professional education courses each year in order to maintain various licenses, and have been taking a one year course to obtain an additional designation. Along with this years move, the combination of these events has taken its toll. I hope to be heading back towards some sense of normalcy before the end of October.

I have included in this edition, various updates including those from the Pension Protection Act of 2006, signed into law on August 17th, and items gleaned from the GA National Association of Tax Professionals meeting I attended on September 24-26th.

The IRS is attempting to close a \$345 billion dollar tax gap by increasing the number of audits related particularly to S-Corporations, and high-income individuals, and also by ensuring that tax practitioners such as myself adhere to professional standards and

follow the law. This means we will have to be extra careful, and do our best to document everything.

Three managers from the Georgia Department of Revenue also attended this years meeting. The state has been holding refunds and reviewing returns when the deductions claimed exceed 40% of income. They are 4-6 months behind, and are really trying people's nerves. I only have one more case pending, thank God.

3rd Quarter Key Dates

[The third quarter began on July 1st, and ends on September 30th.]

October 1 – 15: We need to receive all 3rd Quarter Accounting work on or before October 15th.

October 31: Quarterly Payroll Tax Returns must be in the mail.

October 15: Due date for Individual income tax returns. For extensions filed on April 15th, the returns received an automatic 6 month extension.

Monthly Tax Deposits: Due 15th of each month.

Monthly Sales Tax: Due 20th of each month.

Open 401(K) or SIMPLE: Due by October 1st.

2006 Changes for Individuals

AMT Relief – If you're one of the many taxpayers who is subject to the alternative minimum tax (AMT), you will be glad to know that the new law increases the exemption amount for tax year 2006. The increased exemption amounts are as follows:

\$62,550 for married individuals filing joint;

\$42,500 for unmarried individuals; and

\$31,275 for married individuals filing separate

After tax year 2006, the rates revert to the amounts that applied to the 2001 tax year.

Increased Age Limit for Kiddie Tax – The age of minor children whose investment income is subject to tax at

their parents higher rate is increased from under age 14 to under age 18. This means that unearned income above \$1,700 (for 2006) of a child under age 18 is taxed at the parent's marginal income tax rate. If you have college savings accounts in your child's name, and planned to sell a portion in 2008 when the capital gains rate would be zero, you now have to make sure your child reaches 18 by then; otherwise the gain will still be taxed at the parent's presumably higher rate.

Charitable Contributions – Any donations of clothing and household items that you make to charity after August 17, 2006, won't be deductible unless the donated items are in "good" or better condition. This means the IRS may deny a deduction for items that have minimal monetary value. It also means that you need to be prepared to prove both the condition and the value of your donation. For example, a donation of used socks and underwear will probably be denied.

One exception: If the donation of a single item is not in good condition, but is worth more than \$500, it is deductible as long as you get a qualified appraisal at the time of donation.

Note: Donations of food, paintings, and antiques, objects of art, jewelry, gems, and collections are not subject to the new restrictions.

Cash Donations: You may no longer deduct contributions made in cash, check, or other monetary gifts unless you can produce a bank record or a receipt, letter, or other written communication from the charity. This new substantiation requirement is effective for contributions made beginning after August 17, 2006.

Note: You must have written proof for a deduction, even if it is only \$1 thrown into the Salvation Army holiday kettle. No longer will the courts or IRS examiners take your word on small donations.

Tax-free IRA Distributions to Charities – IRA owners who are 70 ½ or older can give as much as \$100,000 from their IRA to a charitable organization in 2006 or 2007 without recognizing any income on the distribution. This is usually a better deal than being taxed and then

taking an itemized deduction for it. The distribution must be done as a direct rollover from the IRA trustee to the charity.

Offers in Compromise – If you are contemplating making an offer in compromise to settle back tax debts, the IRS now requires that partial payments be made during the time your offer is pending.

- Lump-sum offers including installments of five or fewer payments require a non-refundable down payment of 20% of the offer amount.
- Periodic payment offers require you to maintain the proposed payment schedule while the offer is under consideration.

Note: The partial payment requirement is in addition to the non-refundable application fee of \$150. The new rule became effective for offers received on or after July 16, 2006. In addition, from now on, if the IRS fails to respond to an offer within two years of its submission, the offer is deemed accepted.

Targeted IRA Relief – Under the new law, the higher IRA contribution limits will continue and, in addition, will then increase annually for inflation in \$500 increments. They apply to all types of IRAs, traditional, nondeductible, and Roth.

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|-----------|--------------------|
| 2006 | \$4,000 |
| 2007 | \$4,000 |
| 2008 | \$5,000 |
| 2009 | \$5,000 plus \$500 |
| and later | |

For those ages 50 or older, the new law permanently continues so-called "catch-up" contributions of an additional \$1,000 per year.

Clarification: 401(k) and SIMPLE elective deferrals must be deposited by the month following each payroll. For sole proprietors the final due date for deferrals is January 31st. The employer match may be deposited by the due date of the return including extensions.

Direct payment of tax refunds to IRAs: To encourage greater savings, you will be able to deposit all or part of

your tax refund directly into your IRA account. Beginning with returns filed in 2007, the IRS must make available a form to enable direct deposit of tax refunds to as many as three different accounts, such as checking, savings, and retirement.

Caution: Taxpayers who want their IRA contribution to relate back to the prior year should allow sufficient time for their refund to be direct deposited by April 15.

Rollovers by nonspouse beneficiaries: Beginning on January 1, 2007, nonspouse beneficiaries of deceased person's eligible retirement plan will have the option to roll over the distribution into an IRA tax-free.

Capital Gains and Investments – The reduced capital gains tax rate will continue through 2010. For most taxpayers the rate is 15%. For those in either the 10 or 15% tax bracket, the rate is 5% for 2006 and 2007, and 0% for 2008 through 2010. After 2010 the rates return to 20% and 10% respectively. Also after 2010 the special rate on 5 year property will revert to 18% and 8% respectively.

Qualified Dividends: Qualified dividends will be included as part of net capital gains through 2010. After 2010 dividends will revert to being taxed at ordinary tax rates of up to 35%.

2006 S-Corporation Issues

Officer Compensation for S Corporations – Following are my notes taken during a recent meeting with the IRS Stakeholder Liaison at the GA NATP Annual Meeting in Dillard, GA.

Partnerships – General partners in a partnership are responsible for paying self-employment tax on both guaranteed earnings and on ordinary income flowed-thru to them on schedule K-1. Limited partners generally only pay self-employment tax on any guaranteed payments received.

Sole Proprietors – Net earnings from the operation of a Schedule C business are subject to self-employment tax.

Subchapter C Corporations – Salary payments to officer-shareholders are subject to normal payroll tax withholding rules. As salaries are deductible to the corporation, and the corporation is also subject to income taxes, there are times that excessive compensation may occur.

Subchapter S-Corporations – It is well known that flow-thru income from an S Corporation is not subject to self-employment tax. The main issue the IRS is looking into is that of inadequate compensation to a shareholder employee.

- If a shareholder of an S Corporation performs work related to services for the company, he or she is an employee under IRC 3121(d).
- Rev. Rul. 73-361 states that an officer-shareholder performing services for payment is an employee of such corporation for payroll tax purposes.
- Treasury Regulation Section 31.3121(d)-1(b) states that generally, an officer of a corporation is an employee. However, an officer of a corporation who as such does not perform any services and who neither receives nor is entitled to receive any remuneration is not considered to be an employee. For example, a retired doctor, who no longer performs services, but still receives distributions from a corporation.
- If a shareholder is an employee of the corporation, and any payments or distributions have been made on their behalf, a reasonable salary should be established.

Payroll Tax Implications

- Reasonable compensation for these services is subject to Social Security, Medicare, and State and Federal Unemployment tax.
- Federal Income Tax Withholding is also applicable.

Judicial Precedent

- Radtke v. Comm 90-1 USTC 50113 – The court ruled that distributions received by an S corporation shareholder who performed legal services for company clients were in fact wages subject to employment taxes.

- Spicer Accounting, Inc. v. Comm 91-1 USTC 50103 – The court ruled that distributions received by an S corporation shareholder who performed accounting services for company clients were in fact wages subject to employment taxes.

Also, since the IRS has mentioned the possibility of placing all or part of the blame on tax practitioners, please be aware, that if you do not want to work with me within the set of tax laws laid out before us, then don't be surprised if I decide to sever our business relationship. I take this matter seriously, as do most of my clients, but there are a couple of you who just don't seem to get it.

What is reasonable?

- Factors considered are the type of duties being performed, any special education requirements, number of hours worked and statistical data from employment firms for similar positions in the same geographical area.
- Resources: www.salaryexpert.com, or www.content.salary.monster.com.

Comments: My general rule of thumb has been that at least 50% of the amount taken out of an S Corporation by a shareholder who performs services should be grossed up as salary, with the appropriate payroll taxes being paid either on a monthly or quarterly basis. Some of my peers use a 70-30 approach in order to avoid audits.

There is no exact method, but one thing is sure. If you are a shareholder in an S-Corp, and receive distributions of any type, your distributions can only be classified as one of 5 things: Salary, Distribution of Profits, Loans, Rental Payments, or Reimbursement for expenses. And if you are taking money out of the company to pay your living expenses, and the amount of your salary is not adequate to cover such expenses, you are probably going to be audited.

Reasonable compensation audits are on the rise, and are part of the IRS's agenda to close the \$345 billion dollar tax gap. An audit for reasonable compensation could involve having to file delinquent payroll tax returns along with the penalties and interest for not doing it right the first time. If you have concerns about your compensation, I would suggest you begin getting your quarterly or monthly accounting information in on time, and scheduling appointments to correct the situation as soon as possible.

Sub S Corporation Audits – Are you ready?

Preliminary review of documentation – The IRS will want to review your corporate minute book (if you are Incorporated). They will be looking specifically for notes on Officer's Salaries, Leases, Sales/purchase contracts, bank loans, lawsuits, and new issues of stock.

The IRS will also be looking for notes regarding shareholder loans, annual meetings, and at your stock transfer ledger. The following issues are also subject to review:

Stock Basis – Your stock basis is your original contribution to the company for stock, additional paid in capital and loans to the company plus or minus your cumulative net profit or losses from the time the business began minus K-1 distributions. Non-deductible expenses are also subtracted from your basis such as one-half of the deduction for meals and entertainment, officer's health and life insurance, penalties, etc...

Losses and K-1 Distributions – Losses are only deductible up to the amount of your stock basis. Once losses exceed your basis they become non-deductible until such time as your basis is increased. Your K-1 distributions are treated as taxable capital gains if they exceed your stock basis. A loan or contribution to the company can rectify this if done before year end.

Officer's Health Insurance – In the past, we have advised that health insurance payments made by the S-Corp for an officer were 100% deductible on the officer's personal return as long as the officer's salary exceeds the amount of premiums paid. A recent ruling has changed this. From now on your premiums are only 100% deductible if the health insurance is part of a group health insurance plan which is in your company's name. In many states you must have 2 or more

employees to qualify for a group plan and it may not be economical. You may need to hire a spouse or child in order to qualify, but they should be genuine employees who are paid for the services they perform. Thus for most of us, our health insurance premiums will only be deductible on Schedule A as itemized deductions which are subject to 7 ½% of adjusted gross income (AGI). No one that I know is happy about this, but this is now a fact of life, and something to take up with your congressman, and not your tax preparer.

Company Owned Automobiles and SUV's – If you are taking a write-off for a company owned vehicle, you need to make sure you are keeping documentation on vehicle usage. Mileage logs or other records detailing the use of a company owned vehicle will be scrutinized. If you are going to take the big write-offs, you need to do your part in maintaining a mileage log which records the total mileage for the year, and either the number of business or personal miles driven for the year.

You can maintain this by using a daily mileage log, calendar, or diary. If your vehicle is used 100% for business, then you need to document this in your corporate minute book by stating the policy for vehicle usage. Generally to pass the 100% test, your vehicle must be modified in a way that makes it impractical for personal use (i.e. company name painted on the side, or special compartment for carrying tools or supplies), and you also need to have another vehicle available for personal use.

I ask you for this information at tax time, because the IRS will ask for it at audit time. If your answer is going to be, “use the same as last year”, you need to rethink that position, and start a system of documentation. You can apply this to any other type of expense.

Corporate Accounting Services – In times like this I can't stress enough the need for monthly or quarterly accounting services. No it's not easy to do, and I don't know many people who want to take a pile of receipts, bank statements, cancelled checks and settlement statements and make sense out of them. If you want to wait until the end of the year, or tax time and bring in 12

month's worth of stuff and pile it on my desk, it's probably not going to get done at all.

We provide either monthly or quarterly accounting services. If you have a lot of transactions or difficult ones, you need monthly accounting services. If you don't do many transactions on a monthly basis you probably just need quarterly accounting.

Other considerations – If your federal payroll taxes are greater than \$2,500 per quarter, you must make monthly payroll tax deposits, otherwise you will be penalized. Thus you will require monthly accounting services. If your federal payroll taxes are less than \$2,500 per quarter and your business does not have many transactions, you can get away with quarterly accounting services.

(Real Estate Professionals – Just a reminder that your bank statements are not enough to tell me how much rent you have collected on your rental properties. You need to be keeping up with this and should be able to provide that information. If you need a spreadsheet to keep track, I will be glad to provide one. You can also obtain such ledgers from your local office supply store.)

Quarterly Accounting & Payroll Tax Services – There are basically four quarters in a year. Following are the quarter-end dates, followed by the *due date for quarterly payroll tax returns*. (Caution: There is very limited time between the end of a quarter, and the due date for quarterly payroll tax returns – 30 days.)

1. March 31st – Due on April 30th
2. June 30th – Due on July 31st
3. September 30th – Due on October 31st
4. December 31st – Due on January 31st