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## Small Business Tax News

### 4th Quarter 2005

Special Edition

#### Important Due Dates

- October 8-15<sup>th</sup> – Monthly & Quarterly clients submit bank statements, canceled checks, credit card statements, and other records for 3<sup>rd</sup> quarter accounting and financial statements (July-Aug-Sept).
- October 14<sup>th</sup>
  - Monthly Payroll Tax Deposits due.
- October 31<sup>st</sup> – Quarterly Payroll Tax Returns due.
- October 15<sup>th</sup>
  - Last day to e-file 2004 Personal Income taxes.
- Oct, Nov, and Dec. 20<sup>th</sup> – Sales & Use Tax Returns due.

#### IRS Small Business Audits

Under pressure from the U.S. Congress and the general public, the IRS has begun auditing small businesses on a larger scale than ever before. They have hired new unseasoned auditors to take on the job. The IRS can audit any return filed within the past three years (from the due date, or date filed). We have been given a heads up on some of the items they will be looking into and what you can do to protect yourself in case you are the one out of three who gets audited.

#### Annual Meetings

If your company is a corporation, the first thing the IRS will ask for is to see your corporate minute book. Corporations are required to have at least one annual meeting and to have minutes from the meeting recorded in the corporate

minute book. (Although LLC's are not required to have regular meetings, it is good practice to do so, especially if trips have been taken claiming to have been for the purpose of a company meeting.)

If your business does not have annual meetings, the IRS could determine that you are not doing business as a corporation and disallow your status as a corporation. This could have dire tax consequences. Therefore, if you have a corporate kit please go back through it and make sure you have minutes for each year that you have been in business. Your kit contains an outline for annual minutes. You will want to make several copies of this for future use, or type out the same format for use in the coming years. If you need assistance please call to arrange an appointment, or direct your questions via email.

Following are some of the items that should be in your minute book:

1. A decision to set up a health insurance plan to be paid by the company on behalf of the officer's.
2. A decision to set up a company funded SEP, SIMPLE or 401(k) retirement account.
3. A decision to set a fixed salary for the officer(s), or to establish a minimum salary.
4. A decision to set up a corporate brokerage or other savings account.

5. A decision to purchase a company vehicle including how personal use of the vehicle is to be treated. Personal use is treated as compensation and should be included on the employee's W-2 form as taxable income.
6. A decision for the company to pay for life insurance for its officer's.
7. If employees are to be reimbursed for expenses a decision to establish either an accountable or non-accountable plan. For example, under an accountable plan an employee would submit receipts and be reimbursed for the exact amount, or submit their mileage and be reimbursed based on the standard mileage rate. Under a non-accountable plan the company would agree to reimburse employees for a fixed monthly amount for automobile travel, or other expenses. Your note should correspond to the practices of the business.
8. Self-Rental – A decision for the company to pay rent for use of space in the home of a principal officer. This should be supported by an actual lease agreement between the company and yourself. *If your business is taking a deduction for rent, it is important that an actual rent check be cut each month with a note on the memo line stating, "Rent of the Month of ..."*.
9. A decision to lease an office, or purchase a commercial building for the business.
10. A decision to hire additional staff.
11. Decisions to purchase equipment, or make improvements to your office.
12. Other decisions regarding purchasing or switching telephone service, internet service, travel, planned trips, credit card processing services, advertising etc... can

be noted in the minutes as other decisions made which were later carried out.

Although it not necessary to record every day decision in your annual minutes, the first 9 items are mandatory. You can see from the list above that there are plenty of topics that may be included in your minute book.

### **Reasonable Compensation**

The officer(s) of an S-Corporation are required to pay themselves a reasonable salary.

1. Paying a salary requires monthly or quarterly payment of employment taxes including Federal Withholding, Social Security, Medicare, Federal Unemployment, State Withholding, and State Unemployment. It also requires the filing of quarterly and annual payroll tax returns, and that a Form W-2 is issued at the end of the year.
2. What is reasonable? There is no one rule, but the following are some of the hints provided by IRS.
  - a. A salary that is paid in a regular fixed amount can be considered reasonable.
  - b. Of the total amount of money taken out of the business annually including distributions and salary, your distributions should not exceed 50%.
  - c. Roughly 50% of the total amount taken out of the business by the officer(s) should be salary with some exceptions.
  - d. The salary should be in line with similar positions in your industry.
  - e. The officer's salary should be higher than any other employees,

with the possible exception of commission based employees.

- f. The company should have the cash flow to support the officer's salary including the quarterly tax payments.
3. If the IRS determines that your salary is too low relative the amount taken out as distributions, they will reclassify some of your distributions as salary. This creates other problems such as the fact that payroll tax returns were not filed, or were filed but underpaid in prior years. The IRS will make you correct previously filed quarterly payroll tax returns for those periods and charge interest and penalties for late payment, late filing, or not filing the appropriate returns.
4. If you are not paying yourself a salary, or the amount is low in relation to the income of the business, you may be at risk for an audit.

### **Fringe Benefits**

The IRS is also looking to reclassify certain fringe benefits as compensation or salary. The service feels that businesses are benefiting by deducting amounts paid which are really for the personal benefit of its officers. They will be looking specifically at personal use of cellular phones, meals and entertainment, laptop computers, desk top computers maintained at home, internet service, business use of home phones, company owned automobiles, and dues paid for health or golf clubs. If your expenses in these areas are considered high in proportion to your income, you may be at risk of an audit.

1. If you use a company paid cell phone for business and personal use, the IRS expects you to tally up the personal usage and report that amount as compensation. This also applies if you provide employees with company paid cell phones. The IRS may reclassify personal

usage of cell phones as part of the officer's salary.

2. If your business is taking a deduction for business meals, you must be able to prove who you met with, and what was discussed at each meeting. It is recommended that you write the names of those you met with and the business purpose on the back of your meals receipts. The IRS does not allow businesses to deduct personal meals where there is no business purpose. If the business pays for certain meals because it requires that the employee not leave the premises for lunch, then this policy should be included in the annual minutes or other company resolutions. The IRS may disallow meals expenses if a business purpose cannot be proven or reclassify such as compensation.
3. If your business owns a laptop computer which is used in your home and office, the IRS can disallow the write-off of personal usage, and reclassify the amount as part of compensation. Your company should have an entry in the minutes outlining the policy, such as personal use is prohibited, or when the write-off is claimed you should only deduct the business percentage.
4. If your business owns PC's maintained in your residence in a manner that non-business related use can occur, the IRS can disallow the write-off of personal usage, and reclassify it as compensation. It would be wise to have an extra PC around the house for personal use, and to dedicate your business computers for business only.
5. If you maintain an internet service provider in your home which is being paid for by your business, you need to be able to prove that it is used 100% for business. If this is not the case, then the

company should only pay for the business usage.

6. If your business pays for phone or fax lines maintained in your home, you will need to prove whether or not such phones are for 100% business use. If this is not the case then the business should only pay for business usage.
7. If your company has purchased a vehicle in the company name and it is sometimes used for personal use, you will need to be able to prove that the personal usage was reported as compensation on your W-2. One way around this would be to set a policy in which the employee or officer pays the company back \$3.00 per day for personal usage. Annual mileage logs including the total miles, and either personal or business mileage must be maintained regardless of the method used.
8. Annual dues paid for health or golf clubs are not deductible by a company. The only thing deductible would be business meals provided for those you met with at such places. Meals should be documented by providing the parties that met and a description of the business purpose.

As you can see there are many ways that small businesses owner's can lower their taxes which the IRS would consider to be abusive. You can also see why every month or quarter we ask for documentation including invoices, HUD-1's, receipts, credit card statements, cancelled checks, bank statements, etc...

My job is to help you lower your tax burden legally, to protect you from being audited, and to be able to provide adequate documentation in the event that you are audited. Many times audits are done randomly and if you are audited it does not mean you have done something wrong. Sometimes people get refunds after an audit. The

worst position to be in is to be audited and to not be able to provide documentation to support your deductions.

I would encourage you to help us to help you by getting us adequate documentation in a timely manner so that we can meet the quarterly deadlines, and provide proper consultation on all the legal requirements you face.

Owning a small business requires persistence. We are here to assist, but we do not control your day to day operations. If you are not keeping adequate records please begin doing so now. We would rather receive too much documentation than not enough. The less you tell us, the less we know.

Month's and quarter's pass so fast that I cannot guarantee you that we will have the time to meet the deadlines when we have to ask a lot of questions about questionable transactions. Therefore, please code your checks, receipts and credit card statements, don't destroy your records for four years after your tax returns are filed, provide us with everything you can for every month of the year, review the financial statements and tax returns we prepare, and allow us adequate time to get the job done.

Sincerely,

*Larry Walker, Jr.*  
Enrolled Agent