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Dear Client,

**Quarterly Corporate News Letter – 3<sup>rd</sup> Qtr. 2002**

This is 4-Serenity's first quarterly Corporate News Letter. Quarterly Clients – the end of the third quarter is approaching and it's almost time for us to get together once again to prepare your quarterly financial statements, and to assess your current and projected tax situation. Please contact me as soon as you receive your September bank statement, so that we can arrange for a convenient time to meet. I am including in this edition several articles relevant to small business. If you have any questions or concerns, please feel free to contact me. I am here to help.

**S-Corp Salary**

Unlike a partner in a partnership, the shareholder's share of Subchapter S corporation taxable income is not subject to self-employment tax. However, if the shareholder performs services for the corporation, the shareholder must be paid a reasonable wage (subject to FICA, FUTA, and state unemployment taxes).

**Reasonable Wage For Services**

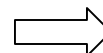
The temptation is to pay little or no wages to the Subchapter S corporation shareholder for the sole purpose of reducing Social Security and other employment taxes. The 7th Circuit in the case of a lawyer who incorporated his law practice, and elected to be a Subchapter S corporation addressed this issue. The lawyer received no wages during the year but was able to take distributions whenever the corporation had funds available.

When the IRS is successful in re-characterizing distributions as wages, the Subchapter S corporation is subject to all of the employment taxes along with penalties and interest for failure to deposit the taxes, and possible failure to file Forms 940 and 941.

**Some factors considered by the IRS and courts to determine if shareholder compensation is "reasonable":**

- Compensation paid for similar positions in other companies.
- Shareholder's background and experience.
- Shareholder's contribution to profit making.

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- Time spent performing services.
- General economic conditions.
- Salary paid to other employees.
- Employer's financial condition.
- Compensation paid in prior years.
- Comparison of compensation to distributions and retained earnings.

**Proposed Regulation §1.1366-3:** In addition to challenging compensation paid to shareholders, the IRS will challenge compensation paid to members of the shareholders' families. If the compensation for services or for use of capital is not reasonable, the IRS will make an adjustment. This adjustment will also carry through to the recipient of the compensation.

### **Hiring Independent Contractors**

In recent years, the IRS has increased its efforts to reclassify payments to independent contractors as salaries and wages. This is because when employers misclassify bona fide employees as independent contractors, the Treasury loses revenue from payroll taxes.

If your business could be challenged on this issue, you should establish that you are properly classifying your workers as independent contractors:

- Use a written agreement between you and the contractor that defines the terms of the project and the contractor's responsibilities
- Make payment upon project completion, rather than on an hourly or weekly basis. Include a statement that the contractor will receive a Form 1099-MISC.
- Don't require full time work (i.e. 40 hours per week); contractors are usually able to specify their own hours.

Most people working for your business are either employees or independent contractors.

### **The Importance Of Annual Corporate Meetings**

Have you heard about the legal theory of "piercing the corporate veil" to make the shareholders the alter ego of the corporation so that the shareholders themselves will be personally liable for its debts?

**There is such a theory!**

There are mistakes that inexperienced or ill-informed people can make causing shareholders to become personally liable for their corporation's debts. That's something you definitely want to avoid. One of the main reasons many people incorporate is to protect their personal assets. How can you begin to prepare to protect yourself?

## **Comply with Corporate Formalities!**

A very important corporate formality is holding annual meetings of shareholders and directors and having written minutes of those meetings prepared and filed in your corporate minute book. When there is only one shareholder, or one director a meeting, of course, cannot take place. In these circumstances the annual written action of the sole shareholder or the sole director should be prepared and placed in the corporate minute book.

If your corporation keeps annual written minutes, or the annual written action of the sole shareholder or director, as the case may be, you will have gone a long way in complying with corporate formalities. To be sure, this is not, in and of itself, a guarantee that your corporate veil cannot be pierced. However, if you are careful about this, and are well informed, you will probably be careful and well informed about other corporate formalities thus helping you to avoid becoming personally liable for your corporation's debts.

## **Forming A Corporation**

There are many services offering to incorporate your business. Most of these do not tell you everything that needs to be done, and do not offer these services. Please feel free to contact me, if I may be of assistance in any of these areas.

## **Here are a few reminders of Required Corporate Formalities**

1. Prepare and sign your corporation's By-Laws.
2. Prepare and sign your corporation's Organizational Resolutions.
3. Prepare and sign the Stock Purchase Agreement.
4. Prepare the Stock Ledger.
5. Prepare and sign the Stock Certificates.
6. Prepare your corporation's Federal Application for Tax ID Number.
7. Prepare your corporation's Federal Application for Tax Elections.
8. Prepare your corporation's State Application for State Tax ID Number.
9. Prepare your corporation's State Application for Sales Tax ID Number (if required).
10. Prepare your corporation's State Application for State Department of Labor ID Number.
11. Obtain your corporation's minute book and put all the papers together in one place.
12. Obtain your Corporate Seal for opening bank accounts and signing documents.
13. Obtain your corporation's business license in your local jurisdiction.
14. Open a Corporate bank account.  
(Keep your personal transactions separate from your corporation's.)
15. Plan your Salary, and file quarterly payroll tax returns.
16. Determine whether to deposit payroll taxes weekly, monthly, or quarterly.
17. If you sell products, plan on filing monthly sales tax returns.
18. File an annual business personal property tax return in your local

jurisdiction.

19. Keep adequate books and records of all corporate transactions.

20. File your Corporate Income Tax returns timely.

21. Pay all Federal and State Tax Liabilities timely.

### **Like-Kind Exchanges**

If you are disposing of real estate or other business property for a gain, you may want to consider a like-kind exchange. This would defer the gain of the property disposed of into the acquired property. Generally, the replacement property must be identified within 45 days of the sale, and the replacement property must be acquired within 180 days. You must use a 'qualified intermediary' to complete the exchange. Contact me ahead of time and I can direct you to a 'qualified intermediary' and consult you on various ways to reduce or defer your tax bill.

### **Simplified Employee Pensions**

Looking for a tax-deductible way to save for your retirement. S-Corp owners can set up a SEP-IRA account for yourself through your business and contribute up to 25% of your salary into the account, from your business. The contribution is deductible to the business, and not taxable to you. You are fully vested in the account from day one, and can take out loans for certain purposes, or penalty free distributions for educational expenses. If you do not have a SEP account, contact me and I will refer you to a qualified financial planner who will get you set up properly. You may make contributions to the account up until your return due date (with extensions), generally by March 15, 2003.

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I hope you find this information useful in your quest 4-Serenity, and I look forward to talking with you soon.

Sincerely,

*Larry Walker, Jr., EA, CTC*