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Small Business Tips

What is Considered Reasonable Compensation?

Payments made to employees who are also stockholders of the corporation are subject to close examination because taxation is based on how the payments are classified.

Wages or Dividends

Broadly speaking, payments to shareholder/employees are either wages or dividends. Wages are subject to withholding, but are deductible by the employer. Earnings of a C corporation are subject to double taxation when dividends are declared. The issue of wages versus dividends varies slightly for C corporations and S corporations.

S Corporations

S corporation shareholders can be tempted to take less wages and more distributions from the S corporation. Distributions from the S corporation are nontaxable to the extent of the shareholder's basis, and are not subject to payroll taxes.

The corporation can also use lower salaries to shift income among shareholders or to change the character of income. Wages are always ordinary income, but nonwage distributions from an S corporation may be taxable in a variety of ways:

- As dividend income if they are distributions of C corporation accumulated earnings and profits (AE&P);
- As capital gain if the corporation does not have AE&P and the distributions exceed the shareholder's stock basis; or,
- They are nontaxable if the corporation does not have AE&P and the distributions do not exceed the shareholder's basis.

NOTE: The IRS is aware of these incentives and may recharacterize distributions as wages that are subject to payroll taxes, plus penalties and interest for late payments.

Coming Soon: Penalty Refunds on Late Tax Deposits

Starting in April 2005 small business taxpayers who make electronic deposits of federal taxes for four straight quarters can obtain a refund of late-deposit penalties paid on earlier deposits made with paper coupons. The refund opportunity applies only to penalties paid in full in the 12 months before the switch to making deposits through the Electronic Federal Tax Payment System (EFTPS). Penalties paid before then do not qualify. Refunds will be automatic so there's

no need to apply for them. The IRS' computers will identify eligible businesses and initiate the refunds.

Here are some answers to commonly asked questions on this new program:

Q. Do I have to start using EFTPS at the beginning of the year in order to qualify for the refund?

A. No. The first quarter counted toward your four quarters of EFTPS use does not have to be at the beginning of the calendar year. If you do not enroll in time to use EFTPS for that quarter, you can start your four quarters of EFTPS use at the beginning of any later quarter.

Q. I'm in a seasonal business and in some quarters I don't have any employees. Will these quarters still count for EFTPS use?

A. Seasonal employers must use EFTPS for four quarters too, but those four quarters may be spread out over more than 12 months.

Q. Which penalty will be refunded?

A. The IRS will "look back" up to four quarters prior to your EFTPS quarters and remove the deposit penalty charged in the most recent quarter. You will want to enroll in EFTPS and use it for four quarters before the deposit penalty charged in the most recent quarter is too far in the past to be refunded.

Q. How long will it take to receive my refund?

A. Refunds will occur on a quarterly basis. The first refunds are scheduled for late April 2005. However, if you have outstanding tax liabilities, the refund will first be applied to those liabilities, and the excess, if any, will be refunded.

Q. After I enroll in EFTPS, if I pay with a check in some quarters, will I still receive the refund?

A. No. To qualify for a refund, you must use EFTPS to pay all Form 941 taxes. This includes any payments that are due with the return.

Q. Do I still have to pay the penalty already assessed?

A. Yes, but if you qualify for the refund you'll get that money back with interest.

How to Get Started

Enroll online at www.eftps.gov, or complete and mail Form 9779, EFTPS Business Enrollment Form. Once you are successfully enrolled, you will receive a confirmation package that contains instructions on using EFTPS, as well as information on how to obtain your Internet Password if you want to use EFTPS OnLine within two to four weeks. In a separate mailing, you will receive your EFTPS personal identification number (PIN) for secure use of EFTPS by Internet or phone. Then you're ready to use EFTPS and participate in the Penalty Refund Program.

If you have any questions about the Penalty Refund Program and EFTPS, please call the IRS toll-free at 800.555.4477 or 800.945.8400.

What is It? Mini §401(k)

Mini §401(k) - A §401(k) established by an employer having one or a very small number of employees.

A mini §401(k) [also referred to as uni-§401(k), solo-§401(k), and individual-§401(k)] is simply a §401(k) established by an employer having one or a very small number of employees. Prior to

the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), it was unusual for a single-employee company to establish a §401(k) plan. While this pension reform legislation did not explicitly create a new type of business retirement plan, it made a number of positive changes to existing laws governing §401(k) plans. With the changes, a different perspective emerged regarding §401(k) plans for small business owners.

Three primary changes enacted under the EGTRRA compelled small business owners to reconsider the §401(k) plan:

- An increase in the maximum allowable elective deferral limit under §402(g);
- An increase in the §415 limit; and
- An increase in the maximum deductible contribution limit combined with a change in the manner in which the limit is determined under §404.

EXAMPLE: Anne is the owner and sole employee of Protégé Corporation and receives annual compensation from Protégé of \$30,000. She would like Protégé to establish a retirement plan for 2004 and is considering both a company pay-all profit-sharing plan and a profit-sharing plan with a §401(k) feature.

If Protégé establishes a profit-sharing plan without a §401(k) feature, the maximum deductible contribution allowed to the plan is \$7,500, which is 25 percent of Anne's \$30,000 compensation. However, if the plan includes a §401(k) feature – a mini §401(k) – Anne could contribute up to \$13,000 on a before-tax basis in addition to the \$7,500 contribution from Protégé for 2004. Anne's before-tax contributions do not count towards the 25 percent deduction limit. Furthermore, the total contribution of \$20,500 does not exceed Anne's §415 limit of \$30,000 (100% of Anne's compensation determined before the reduction for before-tax contributions).

If Anne is at least 50 years old, she could contribute an additional \$3,000 of before-tax contributions as catch-up contributions for 2004.

If Anne's goal is to maximize her retirement savings, the benefits of adding a §401(k) feature are more advantageous as illustrated below:

Plan	2004 Limitation for Anne	Calculation
Mini §401(k)	\$20,500	$(25\% \times \$30,000) + \$13,000$
Company pay-all profit sharing plan	\$7,500	$25\% \times \$30,000$
SEP	\$7,500	$25\% \times \$30,000$
SIMPLE IRA	\$9,900	$(3\% \times \$30,000) + \$9,000$

This example assumes that Anne's sole occupation is running Protégé Corporation. If Anne were employed by another company that also maintained a §401(k) plan (and she is under age 50), Anne's combined 2004 pre-tax contribution to both plans could not exceed \$13,000.

Shareholder Loans Not Sufficient Basis to Deduct Losses

Donald Oren and his wife Beverly did not have sufficient basis in indebtedness to deduct pass-through losses from two wholly-owned S corporations. To increase their basis in the S corporation, the taxpayers purportedly directed loans to the two S corporations by taking a loan out of another corporation they owned.

The series of loans was nothing more than circular transactions between the two S corporations and another controlled entity, involving the taxpayers only as mere conduits with no actual economic outlay. The loans were not secured; interest payments were circular; no independent third-party lender was involved; default by financially stable and expanding corporations was not likely; and loans infused no new capital into the corporations.

The IRS concluded, based on facts and circumstances, that if the S corporations defaulted on the loans, there was no realistic possibility that Donald Oren would be required to repay the loan with his own personal resources. Accordingly, the IRS held that the loans did not increase Mr. Oren's basis in the S corporation under §1366(d)(1)(B) and he was limited to his stock basis to deduct the pass-through losses.

Donald G. Oren T.C. Memo 2002-172

Individual Tax Tips

Initiatives to Identify Unreported Income

One of the Internal Revenue Service's (IRS') priorities is to identify individuals who are filing tax returns but not reporting all taxable income. In addition to increasing the resources devoted to this key area, the IRS has implemented a broad strategy to address these cases.

Document Matching

One part of the strategy is the document-matching program. Payers filed over 1.4 trillion information reports for tax year 2002 (Forms 1099, W-2, K-1, etc.). The IRS matches all information reports to the recipient's return to determine if the income was included. In 2004, the IRS estimates it will initiate contact with over 1.6 million taxpayers whose returns appear to be missing some income based on a comparison of reports from payers.

Unreported Income Audit Selection Tool

The IRS strategy also includes methods to address the issue of unreported income not identifiable through reports from payers, for example the gross receipts of a business. The IRS cautions the public that omissions of income will be detected. In 2002, the IRS began using a new tool for identifying returns with a high probability of unreported income. The tool is known as the Unreported Income Discriminate Index Function (UI DIF).

All returns have traditionally been assigned a DIF "score" during processing that rates the probability of inaccurate information on the return. The UI DIF score combines the DIF score with a score rating the probability that income may be omitted from the return. Prior to UI DIF, the IRS had no systemic method for selecting the returns at highest risk for unreported income.

Many returns now receive a UI DIF score in addition to the traditional DIF score. Auditors are currently reviewing thousands of examinations that were selected based on high UI DIF scores.

While UI DIF is already proving successful in finding returns with missing income, the IRS is coupling UI DIF with a research program to update the formula and make it even more powerful. Additionally, they are developing business rules using multiple year return data to complement the UI DIF formula.

Partnering With Other Agencies

In addition to document matching and UI DIF, the IRS is increasingly using techniques that involve partnerships with other government agencies. Examples of information already being shared or explored include state and local tax return information, audit reports, and asset information.

Itemized Deductions Disallowed Due to Lack of Substantiation

Ms. Smith itemized deductions for the 1999 tax year. She claimed deductions for medical expenses, taxes, charitable contributions, and miscellaneous expenses. The IRS disallowed many of the deductions for various reasons.

Medical Expenses

The petitioner deducted medical expenses of her mother (who was not claimed as a dependent on the return). The mother was a citizen and resident of Sierra Leone, West Africa, for the year.

Under §213(a) a deduction is allowed for unreimbursed medical expenses paid by the taxpayer for the taxpayer's dependent, defined by §152. However, §152(b)(3) specifically excludes from the definition of dependent "any individual who is not a citizen or national of the United States unless such individual is a resident of the United States or of a country contiguous to the United States." Since the taxpayer's mother failed both of these tests, the IRS disallowed the deduction for her unreimbursed medical expenses.

The remaining deductions claimed on the petitioner's return were disallowed in part or fully because of lack of substantiation. The burden of proof for deductions lies with the taxpayer; therefore, sufficient records must be maintained to substantiate the amounts claimed as deductions. When a taxpayer fails to maintain records, but a court is convinced that deductible expenditures were made, the Court should estimate a reasonable amount for the deduction. To do so, the taxpayer must have evidence sufficient to provide a basis upon which to make an estimate. Without it, the courts are not able to approximate an amount.

Taxes

Ms. Smith deducted taxes on her Schedule A for amounts she claims she paid for state income tax withholding, personal property taxes, and other taxes. The IRS accepted the deduction for her state income tax withholding, as the amount was substantiated on the Form W-2 attached to the return. However, she had no way to prove she paid for any other taxes; thus they were disallowed.

Charitable Contributions

Ms. Smith also claimed a deduction for charitable contributions made to "needy people [and] displaced people." Since she had no substantiation that she made such donations to a qualified charitable organization, the Court concluded that she made the payments to individuals and not to qualified organizations. Hence, the deduction was denied.

Miscellaneous Deductions

A deduction for miscellaneous expenses was also reported on Schedule A of Ms. Smith's return. Again she had no substantiation for the deductions, and the deductions were denied.

T.C. Summary Opinion 2003-158

No Returns Filed: Unpaid Taxes Not Discharged in Bankruptcy

Neal Swanson failed to file his federal income tax returns for 1993, 1994, and 1995, so the IRS prepared Substitutes for Return (SFRs) in February 1997 and issued a notice of deficiency in May 1997. In August 1998, Mr. Swanson filed for chapter 7 bankruptcy. He included the unpaid tax liabilities as unsecured priority claims. In December 1998, the Bankruptcy Court released Mr. Swanson from all dischargeable debts. Mr. Swanson argued that the unpaid taxes were discharged in bankruptcy. The Tax Court disagreed.

Under §523(a)(1)(B)(i) of the Bankruptcy Code, if a required tax return was not filed, then that tax liability is not discharged. The Bankruptcy Code does not provide a definition for the term "return." In *Beard v. Commissioner*, the Tax Court stated that a document must satisfy the following requirements to qualify as a return:

- Purport to be a return.
- Be executed under penalty of perjury.
- Contain sufficient data to allow calculation of tax.
- Represent an honest and reasonable attempt to satisfy the requirements of tax law.

Under §6020, the Secretary may prepare a return (SFR) for a taxpayer as an administrative step to begin the assessment and collection process. However, the delinquent taxpayer must sign the SFR before the IRS accepts it as a filed return of the taxpayer.

In conclusion, The Tax Court decided that SFRs do not constitute "returns" for bankruptcy purposes. Mr. Swanson never reasonably attempted to satisfy the tax law requirements himself, and he never signed the SFRs. Since Mr. Swanson never filed a "return" for the years 1993, 1994, and 1995, the unpaid tax liabilities were not dischargeable debts. The Bankruptcy Court did not discharge those liabilities. Accordingly, the IRS was allowed to proceed with collection activities.

Neal Swanson v. Commissioner, 121 T.C. No. 7

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- *Reminders:* The due date for personal returns on automatic extension is August 15, 2004. The due date for Corporate returns on extension is September 15, 2004. The due date for Non-Profit returns on extension is August 15, 2004.
- Quarterly Payroll Tax Returns are due on July 31, 2004. Monthly and Quarterly payers must file and pay all balances due by this date.
- Quarterly Accounting: The target dates for receipt of information is between July 1st and July 10th.
- Personal Net Worth and Cash Flow Statements are available for a nominal fee. If you are interested, please feel free to request a questionnaire and to schedule an appointment.
- Most appointments can be handled through fax, mail, or e-mail. If you feel like you need an appointment, but your schedule won't permit, try sending the information over via fax, mail, or e-mail. This way I have time to review your situation, formulate questions, call, write, or e-mail you back for additional information, and send out a written report. Meeting and consultation fees are still just \$50 per hour, and worth every penny.
- Incoming phone calls. It suddenly dawned on me one day that if I take phone calls from 16 clients per day, of 30 minutes in duration, that my whole day is shot, and my income is zero. Therefore, please don't be offended if you call and someone else answers. If you leave a detailed message with my assistant, Pam, she may be able to help resolve the matter, or will certainly bring it to my attention. I will return your call as soon as I have finished the meeting or project at hand.

This Quarter's Motto - *"We don't quit; until we win."*

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