



# Business Update

## IMPORTANT BULLETIN

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Thanks to you, our business has seen a phenomenal growth in 2008. Sometimes, we need to 'tighten up' some procedures so as to avoid issues and surprises that come up at tax time. Tax time may be too late in some cases to correct these issues and you could lose valuable deductions. Or, more commonly, even when things can be corrected it can take time and effort in addition to penalties and interest.

Recently, I attended continuing education for my tax preparer registration and was alerted to several areas that consistently receive IRS scrutiny. In the hopes of stemming off any potential for problems on either end (yours or ours), outlined below are some important reminders to keep in mind. Remember, these are IRS hot buttons, so you must take careful steps to avoid any potential for their taking issue with how you account for income and expenses.

The areas involved include:

1. Reasonable compensation;
2. Health insurance;
3. Reimbursements;
4. Written policy to expense items under \$500;
5. Documentation of annual and special meetings;
6. Accurately documenting contributions and draws from your corporation
7. Treatment of employees versus independent contractors.

### REASONABLE COMPENSATION

There is a key tax court case that has become a determining standard that the IRS may look to at the time of an audit. Be sure that you have firm ground for the salary that you assign yourself, both from a percentage basis as well as an actual dollar figure. These standards are referred to as the **seven Elliotts standards** because of the court case involved (*Elliotts, Inc. v. Comm.*, (716 F. 2d 1241 (9<sup>th</sup> Cir. 1983))). They are as follows:

1. the shareholder/employee's qualifications;
2. the work performed;
3. prevailing salaries for comparable work;
4. prior earning capacity as a self employed individual;
5. prior years' compensation by the corporation;
6. the size of the business and its complexity; and
7. general economic conditions.

The reason why we bring this issue up is because the IRS is continually asserting its authority to re-characterize dividends (distributions) into *more reasonable* compensation in an attempt to increase the amount paid for shareholder/employees. The IRS has recently created an "inadequate compensation" project to address this compliance issue. Additionally, Congress has received proposed legislation from House Ways and Means Committee Chairman Charles Rangel to subject the distributive share that relates to the service business of the S corporation (and limited partnerships) to self-employment tax.

Additionally, the courts have also established the following tests that seem to indicate that compensation does, in fact, exist:

- Substantial services were performed for the corporation;
- Shareholder/employees received dividend distributions but not wages;
- The corporation has only one shareholder/employee;
- The shareholder/employee-officer owns most of the stock;
- Distributions are called loans;
- Wages were paid in prior years and presently wages decrease at the same time that the dividend distributions increase;
- No employment contract containing a compensation/bonus formula;
- Prevailing salaries for comparable work.

We emphasize this issue primarily because it has been continues to be and will continue to be a “hot button” issue for the IRS to attempt to close the massive estimated \$295 billion “tax gap” of underpaid or underreported income. I have a great deal of newly released information on this subject which I would be happy to share with you if you are interested.

## HEALTH INSURANCE

Late last year, the IRS issued a bulletin (Notice 2008-1) which clarifies how a 2% or more S-corporation shareholder can qualify for the self-employed health insurance deduction. This notice provides that a plan providing medical coverage for the 2% shareholder-employee in an S-corporation is established by the S corporation if one of the following two conditions is met:

1. the S-corporation makes the premium payments for the health insurance policy covering the 2% shareholder-employee (and his or her spouse or dependents, if applicable) in the current taxable year; or
2. the 2% shareholder makes the premium payments and furnishes proof of payment to the S-corporation and then the S-corporation reimburses the 2% shareholder-employee for the premium payments in the current taxable year.

**No deduction if the premiums are not paid or reimbursed by the S corporation.** If the health insurance premiums are not paid or reimbursed by the S-corporation and included in the 2% shareholder-employee’s gross income, a plan providing medical care coverage for a 2% shareholder-employee is not established by the S-corporation and the 2% shareholder-employee in an S-corporation is not allowed the self-employed health insurance deduction under §162(1).

**Premium payments are taxable wages.** In order for the 2% shareholder-employee to deduct the amount of the health insurance premiums, the S corporation must report the health insurance premiums paid or reimbursed as wages on the 2% shareholder-employee’s Form W-2 in that same year. In addition, the shareholder must report the premium payments or reimbursements from the S corporation as gross income on his or her Form 1040. Even though the premium payments are to be included in wages, they are not wages subject to Social Security and Medicare taxes if the requirements for exclusion under 3121(a)(2)(B) are satisfied.

Please note the following examples:

**Example 1 - S corporation pays premiums.** For 2008, Sharon obtains a health insurance policy in her name. The S corporation makes all the premium payments to the insurance company. The S corporation reports the amount of the premiums as wages on Sharon's Form W-2 for 2008 and Sharon reports that as gross income on her 2008 Form 1040. A plan providing medical care for Sharon has been established by the S corporation and Sharon is allowed the self employed health insurance deduction under §162(1) for 2008.

**Example 2 - S corporation reimburses shareholder.** For 2008, Steve obtains a health insurance policy in his name. Steve makes the premium payments to the insurance company and furnishes proof of premium payment to the S corporation. The S corporation then reimburses Steve for the premium payments. The S corporation reports the amount of the premium reimbursements as wages on Steve's 2008 Form W-2 and Steve reports that amount as gross income on his 2008 Form 1040. A plan providing medical care for Steve has been established by the S corporation and Steve is allowed the self-employed health insurance deduction under § 162(1) for 2008.

**Example 3 - shareholder pays premiums without reimbursement.** For 2008, Wayne obtains a health insurance policy in his name. Wayne makes the premium payments on the policy. The S corporation makes no payments or reimbursements with respect to the premiums. A plan providing medical care for the shareholder is not established by the S corporation and Wayne is not entitled to the self-employed health insurance deduction under§162(l).

<b>Checklist to qualify S corporation shareholder for self employed health insurance deduction</b>	
S corporation paid or reimbursed health insurance premiums for 2% shareholder-employee.	
Health insurance premiums paid or reimbursed by the S corporation are added to the W-2 of the shareholder-employee.	
Health insurance premium payments or reimbursements included in the shareholder-employee's W-2 are deducted on line 29 of the shareholder's form 1040 as self-employed health insurance.	

In view of the above information, if we are doing your payroll, you must provide us with your health insurance premium amounts each time we prepare a payroll for you.

## **REIMBURSEMENTS FOR EXPENSES NOT PAID DIRECTLY THROUGH THE S-CORPORATION**

In order to be able to claim business expenses that have been paid by 2% shareholders (or other employees for that matter), you must take the following steps:

1. Establish a valid "Accountable Plan" for business expense reimbursement (sample enclosed);
2. Rigorously track your expenses paid personally on behalf of the corporation by filling out "Expense Reports." (sample enclosed)
3. Do reimburse yourself with the following timelines:
  - A. Reimburse yourself no earlier than 30 days before the expense is incurred;
  - B. Accumulate your receipts and turn in your expense report no later than 60 days after the expense is incurred or paid;
  - C. Pay the amount due no later than 120 days after the expense is incurred.

By following the above guidelines, you should be able to deduct most business-related expenses against the corporation.

## **WRITTEN POLICY TO FULLY EXPENSE ITEMS UNDER \$500**

In order to be able to deduct small items that would normally be depreciated, you should have a written plan in place to deduct those items. The limit on small items is \$500.

## **DOCUMENTATION OF ANNUAL & SPECIAL MEETINGS**

While we are not attorneys and don't give legal advice, we continually hear our clients express that they have been neglecting their corporate formalities. Such things as memorializing annual and special meetings and recording of stock transfers and the like are tasks that often get pushed by the wayside. Do you find that you have neglected keeping up with your paperwork? If so, you're not alone, but you should still give careful attention to this area of your business as you could put your business structure in jeopardy.

If you would like us to assist you in either catching up on your paperwork, maintaining your corporate calendar of tasks or both, please call our office to discuss this valuable service.

## **ACCURATELY DOCUMENTING CONTRIBUTIONS AND DRAWS FROM YOUR CORPORATION**

For most of our clients, we are handling the payroll function of for your corporation and when it comes tax time, we have all the data available to us regarding that aspect of your taxes. However, as a reminder, you should carefully keep track of all cash and property distributions to 2% or more shareholders so this can be accurately reported. In the future, we will be asking for this figure routinely. This is important for a variety of reasons, but it will also help you and us to keep track of the basis you have in the stock of your corporation. When it comes time to sell or cash out of your corporation, you'll save yourself time and effort because you'll have it when you need this information. We should also point out that whenever you *contribute* money or property into your corporation, keep careful track of that and report that to us at tax time as well.

## **TREATMENT OF EMPLOYEES VERSUS INDEPENDENT CONTRACTORS**

This is and always has been a source of IRS and State scrutiny. Be sure that you have all your bases covered when classifying your workers. New guidelines have been issued for workers who want to have the IRS rule on their correct classification. They frequently do this so as to avoid contributing the employer portion of Social Security and Medicare taxes.

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Since most cases of this nature are fact-driven rather than law-driven, it is important that you carefully examine a variety of factors to make sure that you are properly classifying your workers. (Keep in mind that no corporate officer or shareholder is entitled to receive a Form 1099 for services provided as an independent contractor.)

Below is an abbreviated synopsis of some of the more common factors in IRS determinations and classifications of workers versus independent contractors:

**Does behavioral control over the worker exist?** Behavioral control focuses on whether the business has the right to direct and control **how** the work is done, e.g., **how** the worker performs the specific task for which he or she is hired.

**To what extent are instructions given and taken?** An employee is generally subject to the business' instructions about when, where and how to work; an independent contractor is not. Even if no instructions are given, sufficient behavioral control may exist if the employer has the **right to control** how the work results are achieved. Pertinent evidence includes: (1) needing prior approval before proceeding; (2) rendering services personally; and (3) hiring, supervising and paying assistants.

**What training does the business give the worker?** Employees may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods. The business' orientation course, safety seminars and voluntary unpaid educational programs are to be disregarded.

**Do financial controls over worker exist?** These factors illustrate whether there is a right to direct or control how the **business** aspects of the worker's activities are conducted:

**Can the worker realize a profit or incur a loss?** An independent contractor can make a profit or loss whereas employees can only make a profit. IRS discloses that the worker's dependence on the job is NOT a factor.

**Is the workers' investment significant?** An independent contractor often has a significant investment in the equipment or facilities he or she uses in performing services for someone else. However, a significant investment is not required. Pertinent evidence includes: (1) amount of unreimbursed expenses, (2) payment of business and/or travel expenses, (3) furnishing of tools and materials and (4) analysis of lease arrangements between worker and business. The IRS has listed business expenses expected to be found on the taxpayer's business return.

**To what extent does the worker make services available to the general public?** Pertinent evidence includes: (1) Yellow Page advertising, (2) working for more than one firm, and (3) identifying when advertising not required, e.g., use of word-of-mouth advertising and having long-term contracts.

**How does the business pay the worker?** An employee is generally paid by the hour, week or month. An independent contractor is generally paid a flat fee or by the job, even though it is common in some professions, such as law and accounting, to pay hourly. The payment of commissions indicate both are possible.

**What type of relationship between the parties exist?** These factors illustrate how the worker and the business perceive their relationship between each other:

**Does a written contract exist that describes the relationship the parties intend to create?** This is a new factor generally considered of lesser importance by the IRS (but more important by the courts!) as the *substance*, not the *label*, governs the worker's status. A written contract contains other evidence, e.g., method of compensation, what expenses are unreimbursed, and *how* work is to be performed.

**Does the business provide the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay?:** Employee benefits are *only* paid to employees! The IRS surprisingly discloses that W-2's do not necessarily indicate employee status, incorporated workers generally will not be recharacterized as the business's employees, and state law determination (or other government or industry imposed regulations) is not a relevant indicator of employer-employee status.

**How permanent, on-going, is this relationship?** Permanent and indefinite relationships indicate an employer-employee relationship whereas, the IRS divulges, long-term and temporary relationships are not important evidence (e.g., independent contractors can have long-lasting relationships).

**To what extent are the services performed by the worker a key aspect of the regular business of the company?** Is the success of the business dependent, to an appreciable degree, upon the worker's performance? If so, an employer-employee relationship exists. For example, as restaurants need cooks and cashiers and law firms need lawyers, these workers are generally employees. But, even though it is essential for an appliance store employee to retain good accountants, bookkeeping is NOT the store's regular business and therefore this work can be done equally well by independent contractors or employees.

**Factors the IRS now considers of lesser importance:**

1. Does the client/customer have the right to discharge the worker?
  2. Does the works have the right to terminate the relationship?
  3. Can the worker work part time or is full time required?
  4. Must the work be performed on the employer's premises?
  5. Who sets the hours to be worked?
- Must the work be performed in an order or sequence?

**Factors the IRS no longer mentions:**

Are interim oral or written reports required?

**Come to a conclusion and weigh the evidence!** Once relevant evidence in all three categories has been accumulated, each evidence must be weighed before determining the worker's status. In the end, it is still a facts-and-circumstances test!

For more information on protecting yourself, we suggest you visit the web site at [www.nibm.net](http://www.nibm.net) click on **SPECIAL REPORTS & CDs** at the top of the site. Then, scroll down and obtain the publication entitled:

**USING INDEPENDENT CONTRACTORS: A CONCISE, PRACTICAL REFERENCE TOOL FOR SMALL BUSINESS**

You'll find this publication extremely helpful as regards this discussion.

We urge you to call our office at 916-481-5252 to schedule a mid-year appointment to discuss your corporation's tax situation. If you have any questions regarding the information provided in this document, please feel free to contact us. We look forward to working with you on streamlining your business organization efforts.

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