

Financial Fax is back!

Look for Mel Daskal's *Financial Fax* column in future issues of *Agency Sales* magazine.

Assorted Info — Some Good, Some Bad

by MELVIN H. DASKAL, C.P.A., M.B.A.; edited by MORRIS SPECTOR, C.P.A.

“E-file will cut many months off the audit process and will allow us to develop sophisticated analytical tools to better select areas of audit inquiry.”

— IRS Commissioner Mark W. Everson

Would You Like to Pay Your Payroll Tax Deposits — Twice?

Both the IRS and the courts have taken the position (and won) that if you give money to an independent agent to pay an obligation of your business, and they do not do so — you *still* owe the money! This recent case is not the first one involving payroll tax deposits and outside agents. Outsourcing payroll functions has become very common and ADP (whom we frequently work with and recommend) alone processes payrolls for one of six private sector workers within the United States.

But what if you use a smaller and lesser-known company? Say the Nigerian Scam Payroll Tax Deposit Company (just kidding) or even a firm with an innocuous name and (as far as you know) a good reputation. If they do not fully deposit your payroll taxes, who owes the IRS? Well, reread the first sentence in this article!

In this case a medical services company (Pediatic Affiliates) hired an outside firm (PAL Data) to service their payroll accounting needs. The owner of

PAL embezzled tax payments received from Pediatic and other clients. The total funds embezzled from Pediatic alone were \$1.2 million. After the IRS caught the underpayments of payroll taxes, the owner of PAL ended up in jail, while Pediatic won a default judgment against the jailbird-owner for over \$1.2 million (which, given the facts, is probably worth about \$25).

The IRS, of course, billed Pediatic for the \$1.2 million (probably plus interest and penalties) and Pediatic fought it in court — with various logical sounding and creative arguments — *but they lost!* Well, reread the first sentence in this article again. Finally, keep in mind that the owners of a business are usually *personally* liable for unpaid payroll taxes, as well.

The best advice is: (a) to get verifiable proof that the payroll provider has a fiduciary bond to protect you; (b) ensure that payroll tax deposits are being made electronically via the Electronic Federal Tax Payment System (EFTPS) so that you can confirm them; (c) check the reputation of the service company with references, etc.; (d) we conservatively recommend only such firms that are large and publicly-owned —



although we understand that this can be unfair to perfectly reputable smaller firms (sorry); and (e) verify that the payroll tax returns contain your business address, so that all IRS notices will be received by you — and not the payroll service provider.

Business Mileage Changes

As of January 1, 2007, the new rate for either reimbursing or deducting business mileage is 48.5¢ (up from 44.5¢). Medical and moving expense mileage is now 20¢ (was 18¢). Charitable mileage is unchanged at 14¢ (since Congress and not the IRS sets this one). Remember, that's a maximum and not a minimum "no-questions-asked" number for each category — you can always reimburse or deduct less. Also, keep in mind that you *still* must obtain or maintain the necessary records to confirm the mileage numbers.

Possible Tax Savings for C Corporation Owners, if You Don't "Zero-Out"

Assume your corporation has a profit of \$50,000 or less and therefore is entirely in a 15% federal tax bracket. Now also assume that you personally are in a 28% to 35% tax bracket. You could net more after-tax cash by paying yourself a dividend instead of additional salary. Why? The dividend income is subject to a *maximum* federal tax of 15%, while any additional salary is taxed at your highest personal tax bracket. *Plus* your corporation must pay payroll taxes on any additional salary.

So maybe you should leave up to \$50,000 as annual taxable profits and consider paying dividends instead...

CAUTIONS: (1) Keep in mind, you usually can't pay a dividend unless you have positive retained earnings (which can include the \$50,000 profit) from which the dividend can be paid; (2) Have your tax advisor also factor in state income taxes (if any) at both corporate and personal tax rates — to see if this negatively affects this idea; (3) Don't forget tax adjustments for such non-deductible items as 50% of

You could net more after-tax cash by paying yourself a dividend instead of additional salary.

entertainment, officers' life insurance premiums, personal use of business autos, penalties, etc. — before you calculate that *taxable* \$50,000; (4) This won't ever work for the eight categories of "personal service" C corporations, since their corporate tax rate is a *flat* 35% from dollar one.

Credit Card Charges

As interest rates climb, the credit card companies have taken that opportunity to increase their interest charges — sometimes to heights you would not believe! There is a minimum payment required each month that is no higher than legally required (since the credit card company collects interest on all unpaid balances). But what if you don't make even that low minimum payment? Then you fall into their "default" category and see what happens.

Another, more recent notice from another company simply states that the *current* rate for all purchases is 29.99% (unless the account is paid in full each month). Since this was an account I have not used in over a year, I looked back at some old statements of theirs. Their previous rate was 15.99%. Some jump!

If some poor soul cannot even pay the (rather low) minimum required payment — how can he or she ever get out of debt while being charged over 30% a year interest, plus late fees, plus principal payments on the ever-increasing unpaid debt?

Taxpayers Lose Another \$300 Million or So

The much-vaunted IRS electronic fraud detection system was not delivered to the IRS on time. As a result, their "Questionable Refund Program" was able to stop only 34% of fraudulent refund claims — or said another way — 66% of them were paid. The estimated losses were about \$300 million, and the IRS Commissioner has expressed his "outrage." The IRS also paid \$18.9 million to Computer Sciences Corp. — although they failed to deliver the system on time for either the 2005 or 2006 tax filing systems. Are any of you "outraged"?

When Is “Entertainment” not “Entertainment”?

The answer is: When casinos provide it free to high rollers. The IRS has ruled that the 50% reduction in meals and entertainment *does not apply* when it is provided free to the casinos’ big betters. Instead, the costs can be classified as “promotional” expenses and can be deducted at 100%. How about the rest of us? We gladly provide free meals to our big (and small) clients whenever the occasion arises — but we can only deduct 50% of the costs. Obviously, big betters and big customers are not the same in the eyes of the IRS as the poor sales agent or other businesses.

Record Tax Case

In September 2006, Walter Anderson pleaded guilty to federal tax evasion for failing to report \$365 million in income over a two-year period. He evaded about \$200 million in federal taxes. Prosecutors said it was the largest personal-tax case in U.S. history. All the unreported income was supposedly hidden in various offshore accounts, corporations and trusts — with concealed ownerships.

Random Audits of Individual Tax Returns

They’re baaack! The IRS plans several thousand of these line-by-line audits during 2008. This is similar to what they did in 2002 and 2003. “The results will help the Service improve the formulas it uses to select returns for audit.” *Ugh!* (Also, see the quote at the very beginning of this article, which certainly *discourages* e-filing your tax return!)

Securities Trading Losses

This lucky individual taxpayer/lawyer reported profits of \$18.5 million in 1999 and another \$17 million in 2000 from settling a class action lawsuit. He closed his law practice in January 2000 and began securities trading using margin borrowing (great timing). By April 2000, his net trading losses were \$25 million and his account was liquidated after he failed to cover a margin call.

He also failed to make a timely “mark-to-market” election to be classified as a professional and full-time securities trader (which he was — albeit not a very good one). That election would have converted his losses from “capital” to “ordinary” (fully deductible). A late election was filed and (incredibly) the Tax

Court allowed the election. Thus he was able to use the \$25 million of (now ordinary) losses to carryback and offset most of the \$35+ million previously reported income (*L.S. Vines, 125 Tax Court No. 15*). Questions: Why not just go home with the \$35+ million, pay the taxes, invest it all in no-risk U.S. Treasuries — and retire? Ain’t human psychology wonderful — and strange?

Private Debt Collection of IRS Back Taxes

Congress (both parties) is opposed to this idea and so am I. The House has blocked all funds to pay for this program, but the IRS is proceeding anyway and already has turned 12,000 cases (up to 40,000 by the end of 2006) over to private debt collectors — who receive commissions of 25% on anything they collect. The costs of using outside collectors are estimated to be almost eight times as much as if IRS employees performed the same job. Your tax dollars at work.

CAUTIONS: (1) If you do settle your case with one of these private debt collectors, the IRS still retains the right to approve or reject any installment agreement made between the collection agency and the taxpayer; (2) The IRS is already worried that identity theft crooks will try and impersonate these private agencies and obtain all your personal information; (3) For each case turned over, you will receive IRS Letter 3998-C informing you *in advance* of that action — or otherwise beware. (One more time: *the IRS does not communicate with taxpayers through e-mail!*)

One of the three companies selected by the IRS is a law firm in Austin, Texas, where former partner Juan Pena admitted in 2002 that he paid bribes to win a collection contract from the city of San Antonio — and went to jail for the crime.

The IRS taxpayer advocate, Nina B. Olson, warned Congress earlier this year, “Because private collectors will operate under the rules of profit maximization rather than the IRS’s customer-service based policy, the private collectors may have less incentive to safeguard taxpayer rights.” *However:* It’s fairly possible that the new Congress will *cancel* this entire program and force the IRS to collect their own debts — like they are supposed to — perhaps by the time you read this.

Medicare Premiums — No Longer All the Same

The 2007 Medicare Part B premiums are \$93.50 a



month, *but*, for the first time, there are higher premiums for upper-income seniors. The larger your income — the higher the premiums. The premium depends on your modified Adjusted Gross Income (which primarily includes tax-exempt income added to your regular AGI). The monthly premium for 2007 can be as high as \$162.10 a month depending on your income, and will increase in future years. As these increases fully phase in over 2008 and 2009, in 2009 the monthly premium for the highest-income seniors will exceed \$300.

Charitable Contributions of Stock — More Than One Rule

Contributing appreciated stock that you have held over one year to charity is a brilliant and legal tax arrangement. You *generally* get a tax deduction at fair market value without ever paying tax on the increased value of the stock over your cost. But there are different rules that apply:

- For publicly-traded securities donated to a public charity, the fair market value deduction is limited to 30% of adjusted gross income (AGI) — rather than the 50% limit that applies to cash contributions.
- For publicly-traded securities donated to a private charitable foundation, the deduction is limited to 20% of AGI.
- For closely-held stock donated to a public charity, the fair market value deduction is limited to 30% of AGI.
- For closely-held stock donated to a private charitable foundation the deduction is limited to the donor's cost (i.e., tax basis) — and further limited to 20% of AGI.

Do You Want to Deduct \$3,000 — or \$100,000?

In the unfortunate event that you have purchased the stock of a small business (yours or someone else's — including family, friends or former friends) — and that business has failed — be very aware of what is called "Section 1244" stock. If the stock you own falls into that category, you can take an ordinary tax deduction of up to \$100,000 on a joint tax return (up to \$50,000 on all other returns) — which can be used to offset all your other income! Otherwise, with non-Sec. 1244 stock, you could only claim a \$3,000 capital loss deduction (in excess of capital gains, if any).

The stock, of course, must be worthless and meet all these conditions:

- The corporation issuing the stock must be a "qualified small business" with a capitalization of no more than \$1 million at the time the stock is issued. It can be either a C or S corporation.
- The stock must be issued for cash or property other than stocks and securities (and not as compensation for services). Thus, you must acquire the stock by purchase.
- The individual claiming this loss must have continuously held the stock from date of issuance.
- This ordinary loss deduction is only allowed to the original purchaser of the stock. You cannot claim this ordinary tax deduction if you inherited the stock, received it as a gift, or bought it from the original purchaser.
- A corporation, trust or estate is not entitled to claim a Section 1244 loss. However, it is possible for partners in a partnership to claim their distributive share of such a loss.
- The corporation must have derived over half its gross receipts during the five years preceding the loss from business operations — and not from passive income (rents, royalties, dividends, capital gains and other investment income). If the corporation has been in business less than five years, this test applies to the years of its existence.
- However, the preceding rule does not apply if the corporation's deductions exceed the corporation's gross income.
- Losses in excess of the \$100,000/\$50,000 limits can still be claimed as capital losses.
- If the owner of Sec. 1244 stock invests additional funds in the corporation but is *not* issued additional shares of stock (e.g., as "paid-in-capital") — such investments do *not* qualify for a Sec. 1244-tax deduction (bad mistake).
- Adequate records to substantiate the claimed loss must be kept.
- Most lawyers advise that the corporate minutes memorialize the fact that the corporation *is* in fact issuing Section 1244 stock. □

**Watch for Mel's column next month
on "Selling or Buying a Business."**



ABOUT THE AUTHOR:

Mel Daskal has spent his entire professional life specializing in manufacturers' sales agencies and their financial, tax and accounting problems and has represented over 400 such firms during his career. He was formerly the accountant for both MANA and ERA National and was a speaker at all MANA regional seminars and ERA national conferences for over 15 years. His accounting firm, Daskal/Spector Accountancy in Tarzana, California, currently has over 100 sales agencies as clients. He can be reached at (818) 907-1800 or (310) 556-1800.

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One Spectrum Pointe, Suite 150, Lake Forest, CA 92630-2283 • Phone: (949) 859-4040 • Toll-free: (877) 626-2776 • Fax: (949) 855-2973
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