

November 2, 2009

Welcome to the Corporate and LLC newsletter! There's a lot here, please read the entire newsletter. The first section contains information from 2009 and also 2008 legislation that affects 2009. Then you will find issues that are new or updated for 2009. Finally, there are reminders of prior year issues that are still hot topics with the IRS.

### **American Recovery and Reinvestment Act of 2009**

This Act has some interesting provisions:

For months beginning on March 1, 2009, as an employer you can pay \$230 per month for employer-provided transit and vanpool benefits as well as employer-provided parking and it will not be reported as income to your employees. This probably doesn't impact most of you, but some of you might pay for parking in the downtown areas.

The Recovery Act provides a 65% subsidy for COBRA continuation premiums for up to nine months for workers who have been involuntarily terminated. If the worker pays for 35% of the premium, then the employer pays for the remaining 65% of the premium and receives a credit on the Form 941 to reduce the quarterly employment tax liability - or can apply directly to the IRS for a refund.

The Act extends bonus depreciation on NEW property through 12/31/2009. The property must be placed in service prior to 1/1/2010.

Retroactively effective for vehicles bought and placed in service after 2008 and before 2010, the Act increases by \$8,000 the first-year depreciation dollar limit for a passenger auto.

The Section 179 limit is \$250,000. Currently, the limit for 2010 will be \$125,000 and for 2011 will be \$25,000.

**TAX PLANNING NOTE:** Buy your assets and place them in service before 12/31/09.

The choices for carryback of Net Operating Losses to anywhere from two to six years were restricted to 2008 and have NOT been extended to 2009. NOL's can only be carried back for two years for 2009.

### **Worker, Retiree, and Employer Recovery Act of 2008**

The notable item in this legislation is that penalties for late filing of Partnership, LLC and S Corporation returns will be \$89 per partner, member or shareholder per month with a maximum of \$1068 respectively. There is no relief for the S Corporation penalty - if you file late, you will pay the penalty.

### **HR 1424**

As reported last year, the energy-efficient commercial buildings deduction was extended through 12/31/2013.

The energy-efficient home tax credit was extended through 2009. This is for contractors that build new energy-efficient homes and is a \$2,000 credit.

A new credit begins in 2009 for the purchase of qualified plug-in electric drive motor vehicles. This includes street-legal golf carts, and is only good for 2009 - so if you are interested in this let me know and I will send details.

Here's an interesting note - the FUTA tax rate will drop from 6.2% to 6.0% for 2010.

The 15-year write-off for both qualified leasehold improvement property and qualified restaurant property will end in 2009. Spend this money now!

### **NEW AND UPDATED SECTIONS FOR 2009**

#### **Bookkeeping Items**

You must report your business versus your personal use on your cell phone. Cell phones are rarely, if ever, 100% business use and the IRS knows this. Make a determination of the percentage of personal use of your cell phone; we cannot deduct this amount.

Bonus depreciation cannot be taken on used equipment. Please note in the memo section on all asset purchases if the item is new or used at time of purchase.

All meals and entertainment transactions must note in the memo section the name of the client and business purpose or it cannot be deducted.

**You cannot deduct checks that are outstanding as of 12/31 if you have a negative balance in your checking account.**

### **Real Estate**

DO NOT EVER put real estate in a corporation. Your real estate belongs in an LLC. If you put real estate in a corporation you run a very real danger of double taxation upon the sale of the real estate. This is true for S Corporations as well as C corporations; just don't do it.

### **S Corporation Distributions - required policy**

If you take S Corporation Distributions, please make note in the corporate minutes and plan to take these distributions on a quarterly, semi-annual or annual basis. Taking distributions on a monthly basis implies they should be re-classified as payroll.

NEW for 2009 - Make sure your policy includes a statement that you will pay all loans to shareholders back prior to taking distributions.

### **W-2's for Shareholder/Employees of S Corporation - Required Policy**

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## **YOU CANNOT DEDUCT YOUR HEALTH INSURANCE PREMIUMS PAID BY YOUR S CORPORATION UNLESS THEY ARE INCLUDED IN YOUR FORM W-2**

Shareholder/employees must adjust their Form W-2's for the following:

- a. Health insurance premiums paid by the S Corporation
- b. Value of personal use of vehicles owned by the S Corporation
- c. HSA contributions made by the S Corporation for the shareholder/employee

Accident and health insurance premiums paid by the corporation on behalf of a shareholder/employee must be included in wages on the Form W-2; not subject to FICA and Medicare taxes. Shareholder/employees that include the insurance as compensation are allowed to take the self-employed health insurance deduction subject to meeting the other requirements for this deduction.

### **Unreimbursed Employee Business Expenses - required policy**

Partners can generally deduct these expenses against their partnership (both regular and self-employment) income **as long as their partnership agreement says that each partner is responsible for his or her own expenses, that the partner is required to pay expenses on behalf of the partnership, and that the partnership is prohibited from reimbursing the partner.**

If you have partnership expenses, including mileage, you want to deduct on your personal tax return, please be sure to bring me a copy of your partnership agreement with these provisions. Or, you always have the option of having your partnership reimburse you for your expenses.

Business expenses paid by the stockholders of a corporation are **not deductible by the shareholder.** Shareholders need to complete expense reports on a regular basis and be reimbursed by their corporations for out-of-pocket expenses, including mileage. Shareholder-employees can deduct

employee business expenses on Schedule A subject to a 2% AGI limitation, but the reimbursement method is much better overall.

**PLEASE NOTE - YOU CANNOT WRITE JOURNAL ENTRIES AT THE END OF THE YEAR AND ALLOCATE YOUR S CORPORATION DISTRIBUTIONS OR LLC WITHDRAWALS TO EXPENSE REIMBURSEMENTS. EACH REIMBURSEMENT MUST BE MADE BY CHECK FOR THE SPECIFIC AMOUNT OF THE EXPENSE. YOU CAN ENDANGER YOUR LIABILITY PROTECTION - THE JOURNAL ENTRY METHOD CAN BE USED TO "PIERCE THE CORPORATE VEIL".**

### **Keeping Corporate Records**

While a corporation cannot "elect" to not be a corporation, the IRS might find that its operations were indistinguishable from its owners and collapse the corporation using the "substance over form" principle. The IRS has broad discretion to allocate income and deductions between or among two or more taxpayers that are owned or controlled by the same interests.

Keeping the requisite corporate records can avoid the "piercing of the corporate veil" and thus shield shareholders and LLC members from most liabilities. Make sure you:

1. Issue stock certificates if you are a corporation
2. Only issue stock after it is fully paid for
3. Maintain a stock ledger book or member ownership record book
4. Hold regular meetings of directors and shareholders and prepare minutes; for LLC's hold meetings of the members and prepare minutes
5. DO NOT commingle corporate, LLC and shareholder/member funds

The IRS expressly forbids the unauthorized practice of law by tax practitioners. You need to contact your attorney to prepare your minutes or advise you on the process.

### **Loans to Shareholders - required policy**

All loans to shareholders must be documented by Corporate Minutes, a written Promissory Note with repayment terms, and a regular payment

schedule that is strictly followed by the corporation. One strategy - adopt a corporate resolution establishing a \$100,000 revolving line of credit with a 5% interest rate per shareholder. Documentation and regular repayments are the keys. If these rules are not strictly followed, the IRS can terminate the S Corporation election - this is not a good risk to take.

What about loans from the shareholders to the corporation? Same thing - must be documented by Corporate Minutes, a written Promissory Note, and a regular payment schedule with a stated interest rate (market rate only please).

If payments are not made, interest must be imputed even if not paid. Either the shareholder or the corporation will be recognizing interest income.

Your debt to equity ratio should not be greater than 15 to 1; so if you have \$1,000 in common stock and over \$15,000 in debt to shareholders or members you could be considered to be "thinly capitalized". I will be reviewing this area this tax season.

### **Charitable Contributions**

Corporations have a 10% charitable contribution limitation, and S Corporations must pass charitable contributions to their shareholders which are then deducted on Schedule A. You should review your charitable contributions. If your charitable contribution was made with a reasonable expectation of a financial return, i.e. as advertising, then you may be able to re-classify the transaction as advertising.

### **Dividends**

Dividends are taxed at a maximum rate of 15% in 2009. C corporations and S corporations that were previously C corporations have a planning opportunity between now and 12/31/2009. Now is the time to clear out those shareholder loans and prior C corporation earnings and profits at a preferable tax rate.

### **LLC Documents**

Your organizing documents for your LLC should include language that allows special allocations among and between members, a deficit restoration requirement at liquidation, non-reimbursement of member expenses, maintenance of capital accounts, and liquidation rules. If you created your LLC document on-line chances are you don't have this language. You really need to visit with an attorney and get these provisions included in your governing documents.

**\*\*\*REMINDERS\*\*\***

I will need the following documents in order to complete your tax return:

1. Physical count of ending inventory as of 12/31 each year. You must provide me with copies of your physical inventory taken at or about the end of the year. If you do not take a physical inventory at the end of the year, you will have to take a physical inventory prior to preparation of your tax return and I have to perform reasonable calculations to adjust back to year-end. I estimate this will add approximately four hours (\$540) to your tax preparation fee.
2. Automobile mileage logs. I must review your automobile mileage logs for each year.
3. Business policies and procedures. I must have copies of your business policies and procedures on file. See below for some of the policies and procedures you must have on file.

Form W-4 and I-9 reminder:

**You must have current Form W-4's and Form I-9's on file for your employees. Your employees must complete these forms annually, as close to January 1<sup>st</sup> as possible.** The Form W-4 is your authorization to legally withhold income tax from your employee's paychecks. If you withhold income tax without a current year form on file, then you will be subject to severe penalties upon audit by the IRS. The IRS is performing payroll audits at a greater rate than ever; and the penalties can run into the thousands of dollars. Why take the chance? Get those forms completed. And don't forget, the shareholder employees **MUST** complete these forms as well. This is the most forgotten form, and the IRS knows this, and they **WILL** penalize you for not having the form on file for yourself. I know it's

ridiculous, but it's a great revenue raiser for the IRS. Do you want to help them raise revenues with your money? NO. Fill out the forms. One more thing, there is no deduction for payments to illegal aliens. At all. Period. I will not deduct these payments on your tax return and risk a \$5,000 penalty for myself. You can get the Forms by going to my website, saradolphcpa.com, and selecting the Recommended Links button on the left. The 2010 Forms are not available yet, so you need to check for them in late December or early January.

### **#### IRS Regulations #### Policies Required ####**

#### **Material Participation Rules**

The IRS is getting more interested in this area. They like to re-classify the losses you incur in your S Corporation, LLC or partnership as passive losses so you cannot deduct them currently. This can affect you if you have W-2 wages from another job and your S Corporation, LLC or partnership is your second job. So, if you do have other sources of income, this is really important.

The IRS requires "Material Participation" by the taxpayer in order for the taxpayer to classify the activity as a business, farm or ranch, or rental property. If the taxpayer does not materially participate, then the activity is passive and any losses are limited (read "not deductible") and must be carried forward to a year in which they are deductible. The material participation rules are as follows:

1. The individual participates in the activity for more than 500 hours during the year. A spouse's participation counts towards the taxpayer's participation, or
2. The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals for such year; or
3. The individual participates in the activity for more than 100 hours during the taxable year, and nobody else participates in the activity more than the taxpayer; or

4. The individual materially participated in the activity for any five taxable years during the ten previous taxable years; or
5. Based on the facts and circumstances, the individual participates in the activity on a regular, continuous and substantial basis during such year.

You must keep track of your hours if you have another job; especially if you have employees in your business or if someone else also works in the business, such as your spouse.

### **Personal Expenses**

**Do not pay personal expenses from your corporate or LLC account.** You are jeopardizing your liability protection when you pay personal expenses from your business account. Why take the risk?

### **Manufacturing Deduction**

There is a manufacturing deduction for domestic production activities enacted into law by the 2004 American Jobs Creation Act. Although it seems at first that this might not impact you, wait!!! The deduction is for the following five categories of income:

Production of qualifying property, such as tangible personal property, software, sound recordings, etc. (could be you).

Qualified film (may apply).

Electricity, natural gas or potable water (probably doesn't apply).

Construction (lots of you out there in this industry).

Engineering and architectural services (also a bunch here).

Many of you were able to take this credit in prior years, and it turns out that in some cases it was quite substantial. Make sure you keep good records that separate new construction or production from rehab or remodel activities.

**Reasonable Compensation - required policy - Same as last year, still critically important**

The general rule of thumb of 50% compensation/50% S Corporation distributions is **no longer valid**. The reasonable compensation rules strictly apply. If shareholders of an S Corporation take out a distribution of profit they must also take out a reasonable salary. Failure to take out a reasonable salary can result in the IRS reallocating income as compensation, and payment of penalties, interest, and payroll taxes. There is a long and established line of case law in this area so don't believe others when they say you don't have to take a salary! Please document your salary - a good place to start is Salary.com, which will give you a range of reasonable compensation for your position. Also, please document in your Corporate Minutes the reasonable salary you have elected. If you determine that cash flow does not permit current reasonable compensation, then you may document that in the corporate minutes as well, and state that the reasonable salary will be deferred until cash flow permits payment. You must then make the payments; also you cannot take out distributions while you are deferring salary. You may pay back shareholder loans, however, prior to taking reasonable compensation. **I will need copies of the method you used to establish your reasonable salary with your corporate information.** You should plan to pay your S Corporation distributions on a quarterly basis after analysis of your financial statements. S Corporation distributions are intended to be profit-sharing, and should be based on the quarterly profits of the business.

**The disadvantage of taking distributions instead of salary is the effect this has on Social Security benefits, Social Security Disability benefits and retirement contributions. All of these items are based on W-2 wages, so decreasing your W-2 wages can significantly affect the above items. Many times it is better to pay the taxes now in order to reap better benefits in the future.**

NOTE: Document in your minutes any missed wages for the year. That way you can pay them in future years and a sound basis for unusually high wages for any period of time.

## **Contractors Please Note**

Contractors, please remember to create an LLC to hold property. There are tax advantages to this strategy, such as getting capital gain rates upon the sale of the property rather than ordinary income tax rates. If the LLC is owned by a single member, it can be reported on your personal Form 1040 on Schedule E, so a separate tax return need not be required for each LLC.

## **Expensing Policy - Required Policy**

Businesses need to have an expensing policy in place and need to adhere to the policy. The policy should state the dollar amount below which purchases will be routinely expensed, even though the item purchased may have a life longer than twelve months. This threshold must be reasonable for the business in comparison to total revenues and expenses. For example, if your total revenues are \$500,000 then your policy may be to expense all purchased under \$250. A threshold of \$5,000 would clearly be unreasonable.

## **Recordkeeping for Credit Card Expenses**

Business credit cards must be tracked in detail on your books. Each charge must be entered individually and each payment is offset against the credit card balance. At the end of the month, each credit card statement must be reconciled and interest expense recorded at that time. **It is not correct to allocate a payment to various expense categories.** Credit card balances are liabilities and are shown on the balance sheet. You will get into trouble especially at the end of the year when credit card charges from December of the current year show up on the January statement of the following year. These charges must be recorded as prior year expenses - the date the expense was charged. You cannot expense these charges in the following year on the date you make the payment. If you have trouble setting this up please call me. It is critical that you record these expenses correctly.

## **Dividends**

For those individuals in the 15% ordinary tax bracket, or below, the tax rate for dividends is ZERO for 2008 through 2010, pending any change by Congress. This is a great planning opportunity for C Corporations. If your C Corporation has any loans to shareholders or accumulated earnings and profits, you should consider distributing them as dividends during these years.

### **Corporate and LLC Debt**

Some of you have sold personal assets to your corporation or LLC or are allowing your business to make personal note payments for you as business deductions. THIS IS NO LONGER ALLOWED. The IRS is stressing the importance of integrity in note payments. Your business needs to pay you the note payment and in turn you will make the note payment to the bank, mortgage company, etc. The IRS is likely to disallow these payments and convert them to dividends or payroll; this is not a good result. So make sure that your business is not making note payments on notes that are in your personal name.

That's all the fun for now....

Happy Holidays!

Sara