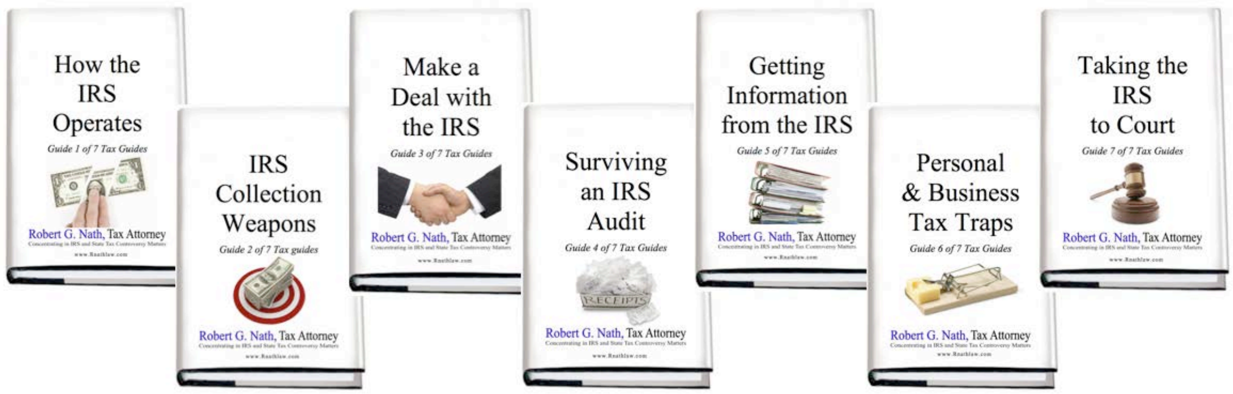
Personal & Business Tax Traps

Guide 6 of 7 Tax Guides

Robert G. Nath, Tax Attorney
Concentrating in IRS and State Tax Controversy Matters
www.Rnathlaw.com



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Written by

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Introduction

Tax Traps for the Unwary Business Person…"Have Records, Sleep Well"…the IRS--a Third Party to Divorce…Protect Yourself from the Divorce Tax Surprise…If You Own a Business; If You Work For Yourself

The American dream often includes owning a business or working for yourself. Millions make this dream a reality every year. In fact, most American business is small business, not big corporations. Upwards of four out of every five jobs exist in nonpublic corporations, from street vendors to multi-billion-dollar family-owned enterprises. Yet, the IRS estimates that more than 30% of income earned by unincorporated business is not correctly reported.

But the American dream can turn into a nightmare over taxes. Even successful small businesses can trip over the many tax rules they must all obey, not to mention the dozens of nontax laws and rules. And, by neglect and inadvertence, a failing business can multiply its tax problems beyond saving. This chapter alerts you to the most common IRS problems that businesses and individuals encounter, and shows how to avoid them.

Prevention is the most important principle.

Choosing Your Business Form

When you start or take over a business, you get to choose the legal form in which you want to operate. You can be a sole proprietor (working for yourself only), a proprietor (you own the business and have employees), a partnership, a limited liability company, or a corporation. "Limited liability" companies and "limited liability partnerships" are common and popular these days. There is no one completely right choice for all cases, but the corporation and limited liability entities have a major advantage over the others. The owners are not personally liable for the corporation's debts. So, if the corporate car runs someone down, or the LLC's machine injures an employee, your personal assets are protected. Only the business assets are at risk.

The proprietorship is the simplest form of business organization. Millions form and do business as "proprietorships." In a proprietorship, you and your business are legally inseparable. You own it all. You receive all the profits or suffer the losses. These features have the advantage of simplicity, but there are disadvantages as well. The biggest is unlimited liability--personal liability for all debts of the business. And, "all debts" means taxes, too. So, if you have employees and fail to pay employment taxes, you are personally liable for all the payroll taxes, plus penalties, plus interest.

A partnership is formed when two or more people unite for the purpose of sharing profits and losses, but they don't incorporate. Again, it's easy to organize, in most states requiring no particular forms ("limited partnerships" require more formalities). The profits are taxed to the partners individually in proportion to their ownership interests; the partnership itself pays no tax. However, the partnership does have a separate legal status and filing and reporting requirements, and so is more cumbersome to manage than a proprietorship. Also, the general partners are totally exposed to personal liability for the partnership's debts. They are also liable to each other for breaches of the duty of loyalty.

Limited liability companies are hybrid entities, created under state law, that intend to give their owners the advantages of limited liability (like a corporation) and partnership tax treatment. For LLCs which qualify, individuals are taxed as if the entity is a partnership. "Single-member" LLCs, or LLCs owned by only a husband and wife, are "disregarded" for tax return purposes; that is, their profit and loss are reported on Schedule C of the individual's tax return. However, an LLC can "choose" to be taxed as a corporation.

A corporation is the most formal type of business organization. All states have laws permitting corporations to be formed and regulating how they operate. Corporations are complex, with many formalities and forms required each year. Regular corporations, called "C" corporations in the tax law, pay taxes on their profits. A special type of corporation, called the "S" corporation, does not. Instead, like partnerships, "S" corporations flow their profits through to the owners in proportion to their ownership shares. An "S" corporation is still a real state-authorized corporation, with limited liability; it has simply chosen to take advantage of the special status the federal tax laws allow for such companies. "S" and "C" status are creatures of the tax laws, not state laws (though many states have analogous flow-through laws because of the federal S corporation tax laws.)

The Tax Traps for Small Businesses

1. Employment Taxes. No matter what form of business entity you choose, you will be subject to filing many different types of business and personal tax returns: federal, state, and local. The most common are employment tax returns. Every business with employees files payroll tax returns, such as forms 941 and 940, W-2, and W-3. Sole proprietors, partners, and corporate shareholders also file estimated tax returns based on their anticipated profit in the business, and corporations annual returns such as Form 1120 or 1120S.

   Businesses that lose money usually run into trouble over payroll taxes more than any other type of tax. The owners or managers pay the employees their net wages, recording on the books the business tax liability for withholding, Social Security tax (which the law calls a “contribution”), Medicare tax, and state income tax. Then they fail to pay these taxes to the federal and state governments. The reasons vary. Often cash flow is tight. Managers may figure that a big payment will come in the next week or next month, or that they can "work it out" with the IRS. They have to keep the doors open, so employees and suppliers get paid, but the IRS doesn't come calling until later-weeks, months, sometimes years later.

   The IRS sounds the payroll tax alarm more quickly these days, but there is still usually two to six weeks of delay after its computers detect nondeposit of taxes or the company sends in a quarterly tax return without full payment. This failure to pay payroll taxes is a ticking time bomb. The corporation, as a separate legal entity, is of course always liable for the full amount of tax, penalties, and interest it fails to pay. But on top of this, the owners and managers who were in control of the company's finances are personally liable for a portion of those taxes, that is, the portion withheld from employees' paychecks. This liability is known as the Trust Fund Recovery Penalty. Guide 2 discusses it in detail. This danger of personal liability is to the single most important reason why you may wish to incorporate your business under state law.

   Members (owners) of a limited liability company can personally liable for the entire amount of payroll taxes that the LLC fails to pay, BUT ONLY IF the LLC is owned by only one or both spouses. The IRS has published guidance that in a single-member (or husband-wife) limited liability company, the member is fully liable for all debts, including all taxes of the LLC. In multi-member LLCs, the LLC is liable for the taxes but the members are liable only for the withheld portions. In short, the IRS respects the “limited liability” character of an LLC where it has at least two members who are not spouses.

   As a rule, the personal liability component of the corporation's tax bill works out to 67-75% of the total tax bill. However, the owners and managers are not personally liable for the penalties or interest.

   If your business is not incorporated, you are personally liable for everything-all taxes, withheld or not, all penalties, and all interest. So, using a corporation has the major advantage of shielding the owners and managers from about one third or more of the total liability for payroll taxes if the business fails to pay the payroll taxes. True enough, a corporation is more cumbersome in terms of paperwork, but many a proprietor and general partner have sadly wished in retrospect that they had simply incorporated their business.

The other single most important practice tip is to keep up the corporate formalities. Being a corporation is not a "file and forget" proposition; the corporation must act like one. That means it maintains its existence separate and apart from that of its owners. The shareholders and directors hold meetings and record minutes. They advertise, write checks, and make contracts in the corporate name. They file all required forms and returns. If not, the IRS, like any other creditor, can hold the owners personally liable for every ounce of tax the "corporation" owed because it wasn't really a corporation. Maintaining these corporate formalities is like getting a dull headache. It nags at you to pay attention and do something, but it's easily done. Yet thousands of corporations are lax in keeping up their corporate records to some extent. The owners are too busy keeping up with business to worry about "the paperwork." When a crisis hits, they wish they had.

2. Employee-Independent Contractors Disputes. The other major payroll problem some companies encounter arises out of treating workers as “independent contractors” rather than employees. A business must pay its employees' withheld payroll taxes (plus the employer's share of Social Security/Medicare), but not if the workers are "independent contractors (that is, not “employees"). The problem arises when the IRS thinks you had so much control over your independent contractors that they should be considered your employees.

   Helpful Hint: The law classifies certain workers as “statutory employees.” This means they are not really employees, but the law makes them employees anyway (for withholding purposes). This includes certain insurance salesmen, homeworkers, traveling salesmen, corporate officers, and certain drivers.

   All of a sudden, your business is liable for a ton of payroll taxes, sometimes going back years. For years, the IRS has fought a nationwide running battle with the business community over this issue. The courts have ruled in dozens of cases involving nurses, drywall installers, insurance agents, teachers, doctors, and other worker classes. Even Congress gets into the fight from time to time, usually granting some measure of relief to businesses that are stuck with these types of investigations. It continues to be a nagging problem. The easiest way to solve it is to give in: treat all your workers as employees, subject to withholding. But many businesses cannot do this because competitors refuse to do the same. Others simply see more profit in using independent contractors. These businesses run the risk of an IRS investigation.

   If you treat your workers as independent contractors, some steps may help your case. Note that the following information is not intended to be exhaustive. You may research this issue in greater detail on irs.gov.

1. Use a written contract that addresses the factors the IRS considers in deciding whether your workers are independent contractors or employees. Then, be sure your business practices conform to the contract. Among the most important factors are the degree of control you exert over the workers' methods, including your instructions and training. The IRS also looks at whether the workers are free to work for others, whether they furnish their own tools, how they are supervised and paid, where the work is done, who pays the expenses, and who bears the risk of loss.

2. Collect information as you go along about how your competitors treat their workers. If a substantial portion of your industry consistently treats workers as independent contractors, assemble that evidence. It may help if you are investigated.

3. Treat your workers consistently as independent contractors, from day one. You will have at least a few real employees, so your payroll tax returns will reflect the withholdings from the true employees' wages. Exclude independent contractors from those returns; instead issue Forms 1099 to report your payment to these workers.

4. Try to find a way to ensure that the independent contractors have paid their income and self-employment taxes. In the real world, this is easier said than done. But if you can conveniently police their tax behavior, the IRS should give you credit for each worker whose taxes have been paid, even if that worker ends up being your "employee."

Tip: *Use Form 4667 in each case. This is a form which certifies (when signed by the worker) that the worker has paid the relevant taxes on his own return.*

Keeping Business Records

These days, there is no excuse for keeping sloppy or incomplete business records. Even small, start-up businesses can and need to keep their accounting and other records by computer. Hardware and software are so inexpensive, so easily available, and such a great help to bookkeepers and executives alike that record keeping should be smooth and easy. The biggest advantage of computerization of business records is that you enter data only once. From those entries you generate accurate income and expense reports, profit and loss statements, balance sheets, and many other reports. Today's computers can crunch the numbers into any form that seems convenient or useful to you. You avoid losing deductions and avert unreported income problems. Tax software will keep you abreast of all deductions, including depreciation. The software also reminds you of tax sensitive dates such as filing deadlines and payroll tax payment deadlines. The computer will catch any arithmetic mistake as well.

Another big advantage of computerization is to enable you to separate your accounts. Businesses and their owners should be separate (even if the owner is an unincorporated proprietor). This is easy with a computer system. Every month, quarter, or year, print a hard copy of your financial statements. Back up your data off site, and maintain the integrity of your business's computer systems by having an accountant who can check behind you.

The IRS Education Program

The IRS publishes a number of excellent guides to help you start your business. Publication 4591, Small Business Federal Tax Responsibilities (PDF) is self-explanatory. Other publications contains tips on the records that are required, a suggested record system, comments on bookkeeping and record-keeping systems, and explanations of accounting methods. Go to irs.gov and type “small business” in the search box. This will bring up the IRS Small Business Center, an excellent source for vital information.

With so much help available from the IRS and from commercial publishers, including computer hardware and software makers, starting a business these days is relatively easy. True enough, it's up to you to make the sales and service the customers. But at least the compliance portion has been made easier.

Divorce and Separation

With half of all marriages ending in divorce and many divorcing couples owing back taxes, it's no wonder the IRS is the "third partner" in many divorces. Divorce taxation is a field of study in itself. Divorce lawyers routinely (though not always) plan for the tax issues in their cases and take advantage of the breaks the Internal Revenue Code gives divorcing couples. People bargain over many tax-related items in a divorce: who gets the house, who gets the insurance and retirement accounts, how much alimony and child support are to be paid, who can claim the kids as exemptions. The Internal Revenue Code has rules that treat each of these issues.

While those helpful rules may smooth the way toward understanding the tax results of property transfers incident to divorce and separation, they have no effect on what happens when taxes have to be collected. For instance, special rules allow couples to fix alimony and child support so these items are deductible by one spouse and reportable as gross income by the other. The Code also allows very liberal transfers (tax-free or deferred) of property, such as of homes or retirement accounts, without paying any current tax. But these rules do not bind the Collection Division when it goes out to collect delinquent taxes. Divorcing couples, and unfortunately sometimes their professional advisers, often overlook many tax traps in the often rocky road to a divorce or separation.

How the Problem Arises

Most tax collection problems in divorce track back to one basic fact: When you and your spouse sign a joint federal income tax return, you are each "jointly and severally liable" for the taxes on that return. By your signatures each of you (“several”), and both together (“joint”) agree to pay the entire tax due. This means the IRS can collect the whole amount from either one, or some from one and some from the other. This is true even if one spouse earned no income and the other earned it all.

The other major principle that causes tax collection problems after a divorce or separation is that the IRS is not bound by clauses in a divorce or separation agreement that allocate the tax liability between the divorcing spouses. These two principles play themselves out in a number of very common situations.

1. We'll call the first one, "<u>But he promised to pay</u>." John and Jane's divorce decree makes John liable to pay the taxes on their past returns and any taxes that might become due if the IRS audits those returns. Two years after the divorce comes the dreaded audit. The result is a $10,000 bill. Jane waves the divorce decree in the IRS' face, but the agent scoffs. "You signed the joint return; you pay the extra tax." This agent would be entirely within his or her rights to demand payment from Jane (unless she qualifies as an "innocent spouse.") This scenario and its many permutations are common in the world of divorce and separation. You can beg and plead all you want, but the IRS still has the right to come after either spouse.

   To make matters worse, the more irresponsible spouse has moved to Moose Breath, Minnesota, leaving the wage-earning, responsible spouse exposed to the tender mercies of the Collection Division. Sometimes, agents take pity and try to locate the wandering spouse, but until the 1996 Taxpayer Bill of Rights, there was no such legal requirement. Now, agents must tell you generally of their efforts to collect from the other spouse if you ask.

2. The issue also can be built into <u>property transfers</u>. A key part of many divorces is property transfers of assets such as bank accounts, retirement accounts, insurance policies, and the big one, the "marital home." Generally, the tax laws allow these to be transferred tax-deferred (deferring the tax on the built-in profit). That profit makes these assets even more exposed to the Collection Division's outstretched hand. And if any has to be sold or if the IRS sells them, there is often a huge tax to be paid on top of everything else.

   <u>Example</u>: Tarzan and Jane divorce. Jane receives the couple's one thousand shares of Megaplex Corporation, worth $50,000. The shares cost $10,000. Jane pays no tax on the transfer of these shares to her in the divorce. After the divorce, the IRS comes after Jane for $50,000 in taxes on the joint return, even though Tarzan had earned all the money. The IRS seizes the stock, sells it for $50,000, and goes away satisfied. Jane has not only lost her stock, but also, because of the IRS' forced sale, she is now liable for the tax on $40,000 profit.

Sometimes a divorce gives the more exposed spouse other valuable assets the IRS may want to seize. An example would be if Jane got the marital tree house from Tarzan in the divorce. Since the divorce gave Jane sole title, the house is no longer protected by the “tenancy by the entireties” rules of most states. Such laws normally protect a home owned by a married couple from the clutches of creditors, including the IRS, where only one spouse owes taxes. (But a 2002 Supreme Court case weakened this protection.) So, in addition to having to pay Tarzan's taxes, Jane must do so with the equity in her only asset, the home.

Negotiating with the Collection Division after a Divorce

If you are the "innocent" victim after a divorce, you can still take steps to help your collection situation. First, go to the source. Find your ex-spouse, demand that he or she live up to the divorce decree. Let the IRS know you have done that. Though this is sometimes easier said than done, most states have laws allowing a spouse to haul the delinquent into court for contempt if he or she violates a divorce decree or property settlement agreement. A clause in Jane's divorce decree requiring Tarzan to pay the back taxes won't bind the IRS, but it will bind Tarzan on pain of contempt of court if Jane enforces it. This contempt power is a potent weapon. If you exercise it, often the IRS will hold off and allow some time to straighten things out with your ex-spouse.

You can also ask the IRS to give you a statement on whether it has tried to collect from your Ex, and how much it has collected. While that's all the IRS has to do, the information may still be useful in trying to pursue the Ex.

If that does not work, all is not lost. Granted, you are in the position of trying to convince the Collection Division that you can't pay, or can't pay much, but here your divorce decree can still help. Sometimes the decree requires you to pay money to your ex-spouse, such as for maintenance, child support, or other "health and welfare" expenses. So, when you fill out the IRS' financial statement (Form 433-A or 433-F - see Guide 3), cite the divorce decree as authority that those hefty payments have collection priority over the claim of the IRS. If the payments are ordered by a court and are reasonable in amount, the IRS should allow them as "allowable" living expenses ahead of its claim. If so, the amount you have to pay to the IRS might well be reduced. You also can try to negotiate an "offer in compromise." Guide 3 discusses this technique. The general idea is: With all your expenses and payments under the divorce decree, you will never be able to pay the full tax bill. So the IRS should take a reduced amount.

Protecting Yourself, Anticipating Problems

Most of these problems can be avoided by some careful planning. When you review a divorce or separation agreement, think in "what if" terms. What if the spouse who promises to pay the taxes does not? What if you can no longer find him or her? By asking these questions in advance and assuring yourself of reasonable answers, you go a long way toward protecting yourself, your family, and your assets from the "third partner" lurking outside the divorce court, the IRS.

Summary of Tips

1. When you run a small business, pay more attention than you think necessary to keep accurate, careful, computerized records.

2. Choose the right business form - don't get caught by the personal liability tax trap.

3. Think through your employment tax issues thoroughly.

4. In a divorce or separation case, anticipate the audit and collection problems that accompany many divorces.

About the Author

Robert Nath is nationally recognized as an authority on tax matters. He holds degrees from Yale, the University of Pennsylvania, and Georgetown University. After clerking for a federal judge, Mr. Nath litigated tax cases for 8 years with the Tax Division, U.S. Department of Justice. Since 1984, he has been in private practice advising taxpayers, accountants, and attorneys on tax procedure and controversy matters, as well as representing them before the IRS and in court in tax collection, audit and tax litigation matters.

Mr. Nath is the author of numerous publications, including:

- "The Unofficial Guide to Dealing with the IRS" (Macmillan),
- "Personal & Business Tax Traps Guide,"
- "Getting Information from the IRS Guide,"
- "How the IRS Operates Guide,"
- "IRS Collection Weapons Guide,"
- "Surviving an IRS Audit Guide,"
- "Make a Deal with the IRS Guide,"
- "Taking the IRS to Court Guide."

Mr. Nath's views have been noted in New York Times, the Washington Post, The Wall Street Journal, the Los Angeles Times, Business Week, Money, Kiplinger's Personal Finance and other national business periodicals on tax procedure topics, appeared on radio and television programs, edited professional journals and his articles have appeared in law reviews and other legal periodicals.

Mr. Nath is a former Green Beret (Major) in the United States Army Reserve.

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1775 Wiehle Avenue, Suite 400,
Reston, VA 20190

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