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Tax & Business Alert

JULY 2015

SUMMER TIME IS A GOOD TIME TO START PLANNING AND ORGANIZING YOUR TAXES

You may be tempted to forget all about your taxes once you've filed your tax return, but that's not a good idea. If you start your tax planning now, you may avoid a tax surprise when you file next year. Also, now is a good time to set up a system so you can keep your tax records safe and easy to find. Here are some tips to give you a leg up on next year's taxes:

- *Take Action When Life Changes Occur.* Some life events (such as marriage, divorce, or the birth of a child) can change the amount of tax you pay. When they happen, you may need to change the amount of tax withheld from your pay. To do that, file a new Form W-4 (Employee's Withholding Allowance Certificate) with your employer. If you make estimated payments, those may need to be changed as well.

You'll need your supporting documents if you are ever audited by the IRS.

- *Keep Records Safe.* Put your 2014 tax return and supporting records in a safe place. If you ever need your tax return or records, it will be easy for you to get them. You'll need your supporting documents if you are ever audited by the IRS. You may need a copy of your tax return if you apply for a home loan or financial aid.
- *Stay Organized.* Make tax time easier. Have your family put tax records in the same place during the year. That way you won't have to search for misplaced records when you file next year.

If you are self-employed, here are a couple additional tax tips to consider:

- *Employ Your Child.* Doing so shifts income (which is not subject to the Kiddie tax) from you to your child, who normally is in a lower tax bracket or may avoid tax entirely due to the standard deduction. There can also be payroll tax savings, plus the earnings can enable the child to contribute to an IRA. However, the wages paid must be reasonable given the child's age and work skills. Also, if the child is in college, or is entering soon, having too much earned income can have a detrimental impact on the student's need-based financial aid eligibility.
- *Avoid the Hobby Loss Rules.* A lot of businesses that are just starting out or have hit a bump in the road may wind up showing a loss for the year. The last thing the business owner wants in this situation is for the IRS to come knocking on the door arguing the business's losses aren't deductible because the activity is just a hobby for the owner. If your business is expecting a loss this year, we should talk as soon as possible to make sure you do everything possible to maximize the tax benefit of the loss and minimize its economic impact. ■

COMBINED BUSINESS AND VACATION TRAVEL

If you go on a business trip within the U.S. and add on some vacation days, you know you can deduct some of your expenses. The question is how much.

First, let's cover just the pure transportation expenses. Transportation costs to and from the scene of your business activity are 100% deductible as long as the primary reason for the trip is business rather than pleasure. On the other hand, if vacation is the primary reason for your travel, then generally none of your transportation expenses are deductible. Transportation costs include travel to and from your departure airport, the airfare itself, baggage fees and tips, cabs, and so forth. Costs for rail travel or driving your personal car also fit into this category.

The number of days spent on business versus pleasure is the key factor in determining if the primary reason for domestic travel is business. Your travel days count as business days, as do weekends and holidays if they fall between days devoted to business, and it would be impractical to return home. *Standby days* (days when your physical presence is required) also count as business days, even if you are not called upon to work on those days. Any other day principally devoted to business activities during normal business hours is also counted as a business day, and so are days when you intended to work, but could not due to reasons beyond your control (local transportation difficulties, power failure, etc.).

You should be able to claim business was the primary reason for a domestic trip whenever the business days exceed the personal days. Be sure to accumulate proof and keep it with your tax records. For example, if your trip is made to attend client meetings, log everything on your daily planner and copy the pages for your tax file. If you attend a convention or training seminar, keep the program and take some notes to show you attended the sessions.

Once at the destination, your out-of-pocket expenses for business days are fully deductible. Out-of-pocket expenses include lodging, hotel tips, meals (subject to the 50% disallowance rule), seminar and convention fees, and cab fare. Expenses for personal days are nondeductible. ■

TAX CALENDAR

July 15

- If the monthly deposit rule applies, employers must deposit the tax for payments in June for social security, Medicare, withheld income tax, and nonpayroll withholding.

July 31

- If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through June exceeds $500.
- The second quarter Form 941 (Employer's Quarterly Federal Tax Return) is also due today. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until August 10 to file the return.

August 17

- If the monthly deposit rule applies, employers must deposit the tax for payments in July for social security, Medicare, withheld income tax, and nonpayroll withholding.

September 15

- Third quarter estimated tax payments are due for individuals, trusts, and calendar-year corporations.
- If a five-month extension was obtained, partnerships should file their 2014 Form 1065 by this date.
- If a six-month extension was obtained, calendar-year corporations should file their 2014 income tax returns by this date.
- If the monthly deposit rule applies, employers must deposit the tax for payments in August for social security, Medicare, withheld income tax, and nonpayroll withholding.

AVOIDING AN INADVERTENT TERMINATION OF S CORPORATION STATUS

An inadvertent termination of a company's S corporation status can mess up even the best tax planning intentions. Here are some important considerations and suggestions to help avoid an inadvertent loss of the company's qualification to be treated as an S corporation.

100-Shareholder Limitation. The S election will terminate if the number of S corporation shareholders is more than 100 at any time during any year. Therefore, it is important to monitor future stock issues so that the 100-shareholder limitation will not be exceeded. A shareholder agreement can help avoid termination of the S election by prohibiting the transfer of shares that would result in more than 100 shareholders.

Ineligible Shareholders. An S corporation can generally have only shareholders that are (1) individuals who are U.S. citizens or residents, (2) estates, and (3) certain types of trusts. Ineligible shareholders include nonresident aliens, partnerships, corporations, and nonqualified trusts. Therefore, it is important to continually ensure that all the shareholders are eligible to hold S corporation stock.

A shareholder agreement is one of the most important tools available to protect the corporation's S election from termination because shares have been transferred to an ineligible shareholder. Such an agreement should prohibit the transfer of any shares to a person other than a permitted S corporation shareholder.

One Class of Stock. An S corporation can have only one class of stock. This means that all outstanding shares must confer identical rights to distribution and liquidation proceeds. The rules do provide, however, that an S corporation can issue both voting and nonvoting stock without violating the one-class-of-stock rule. This rule is complicated, so be sure to contact us when considering future changes to the capital structure of the corporation or when drafting agreements that may affect distribution and liquidation rights.

Excess Passive Investment Income. If a corporation has more than 25% of its gross receipts from passive investment sources in three consecutive years and has C corporation Accumulated Earnings and Profits (AE&P) at the end of each year, then S status is terminated as of the beginning of the fourth consecutive year. An S corporation will generally have AE&P only if it previously operated as a C corporation or acquires a C corporation in a tax-free reorganization.

Corporate records tracking the corporation's passive investment income should be maintained to determine whether the 25% limitation will be exceeded. If a corporation is in danger of going over the 25% passive income limitation for three consecutive years, termination of the corporation's S status can be avoided by distributing the AE&P to shareholders. Furthermore, if the corporation lacks the cash or liquid assets to make the distributions, the corporation can elect to make a "deemed" dividend. If such an election is made, the corporation acts as though a distribution has been (1) paid to the shareholders and (2) contributed back to the corporation. Any distribution of AE&P, however, whether actual or deemed, is taxable to shareholders as a dividend.

If distributing the AE&P is not feasible, it may be possible to avoid termination under the passive income rules by arranging the corporation's operations so that the 25% passive income limit is not exceeded for three consecutive years. To accomplish this, the corporation could (1) reduce the amount of passive investment income, (2) increase the amount of other income, or (3) a combination of both.

Let Us Help. These rules are complex, and some of the procedures apply only if special tax elections are properly filed with the IRS. If you have any questions or if you are considering implementing any of these procedures, please do not hesitate to contact us. ■

ROLLOVERS FROM QUALIFIED PLANS TO IRAS

Employees who quit or retire will often have to decide whether to leave their qualified retirement plan account [e.g., 401(k) account] alone or to roll it over to an IRA. The answer, of course, depends on the individual's specific circumstances. However, there are some general pros and cons to consider.

- *Postmortem Tax-deferral Opportunities.* Beneficiary designations as of the date of the owner's death control the availability of various postmortem tax-deferral opportunities. Therefore, it is important to set up these designations to maximize those opportunities. Greater flexibility generally is afforded in beneficiary designations for IRAs and in stretching out the tax-deferral period.
- *Investment Choices.* Although some qualified plans offer self-directed accounts, many restrict the available investment choices. However, most IRA providers offer their entire investment portfolio for the participant to choose from. On the other hand, the qualified plan may provide access to better investment opportunities (such as a chance to buy a more favorable class of mutual fund shares) than would be available to the IRA.
- *Availability of Taking Withdrawals.* While most qualified plans restrict the availability of withdrawals, IRA withdrawals are available at any time and in any amount. However, an employee who separates from service at age 55 or older can take distributions from the qualified plan without being subjected to the 10% early withdrawal penalty. With an IRA, the employee may have to wait until age 59½ to take penalty-free distributions.
- *Applicable Fees.* IRAs may be subject to fees not charged to the qualified plan account.
- *Creditor Protection.* Qualified retirement plans have federal creditor protection in the case of malpractice, bankruptcy, divorce, business problems, or creditor problems. IRAs are not protected in all states.

Please contact us if you have questions about qualified plan rollovers or the tax aspects of retirement saving. ■