LEE R. PHILLIPS

TOOLS OF WEALTH

USING THE LAW TO MAKE MONEY

FIVE

LEE PHILLIPS SHARES THE LEGAL TOOLS OF WEALTH WITH YOU

GOT QUESTIONS?

What are your needs, concerns, or challenges?

Email Lee with questions you would like to see answered in this newsletter.

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FUND YOUR COMPANY WITH STOCK OR DEBT

By Lee R. Phillips, JD
United States Supreme Court Counselor

I have always stressed that your little company is actually one of your most valuable tax shelters. Hopefully you have already formed a little company. It may be for your real estate flipping, your buy and hold real estate, a flower shop, or any one of a thousand different reasons. For purposes of this article, it doesn't matter what your company does or how it is structured (sole proprietorship, LLC, corporation, S corporation, etc.). Your company can give you asset protection and great tax advantages.

When a company is formed, a stock ledger

should be completed and stock certificates issued. (In an LLC, it is called a membership

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HOW TO AVOID A TAX AUDIT

By Kristy S. Phillips, JD
US Supreme Court Counselor

April 15th (actually it was the 18th this year) has come and gone and you have probably moved on, glad to forget about taxes. You may be hoping it's all behind you, but odds are higher than ever before that you could be up for a tax audit.

Thanks to the staggering federal deficit, the IRS is trying to close the $300 billion gap between what Americans pay in taxes and what the government thinks we should have paid. You probably aren't paranoid that someone is out get you, but the IRS could be.

The IRS recently had a number of job postings for Internal Revenue Agents in the Abusive Transactions Group. The job description is for agents who conduct tax examinations of individuals, sole proprietorships, small corporations, partnerships and fiduciaries.

In this land of equality, not all individuals or companies are treated equally when it comes to chances of being audited. Profiling is alive and well at the IRS. About one in a hundred businesses with less than $10 million in assets is audited. That number jumps to 10 in a hundred for those with $10-$50 million in assets, and one in four for businesses with assets greater than $250 million.

Certain industries are scrutinized more heavily too. You can probably guess some of them—cash businesses are always high on the IRS hit list. But would you suspect Dr. Doggie, the vet, is a target too? It turns out the IRS has a special auditor guidebook for veterinarians, ministers, laundromats, car dealers and many others too. The auditors are trained on specific strategies for interrogating e-commerce businesses, gas stations, direct sellers, mobile food vendors, pizza shops and the like. This group targets taxpayers who generally have higher incomes, need to file more tax forms, and generally need to rely more on paid tax preparers.

Even if you aren't wealthy, don't operate a cash business, and don't have a CPA filing reams of forms for you, you can easily become an IRS target. Your chance of an audit is double what it was just ten years ago. Twice as many tax returns were audited in 2009 as compared to 2000. Enforcement revenue over the same period was up 50 percent.

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FUND YOUR COMPANY WITH STOCK OR DEBT, CONT.

certificate. In this article the term "stock" applies to your ownership in a corporate entity or an LLC.) It turns out, that many company owners never went through the steps of filling out their stock certificates and ledgers. If you are one of those, it is important that you do this "maintenance" requirement so your company can give you the asset protection you need. Go back and do it NOW!

When you "capitalized" your company, you put money into it, and that was the justification for getting the stock back. You bought the stock in your little company. You may not have thought of it that way, but that's what happened. There wasn't any tax consequence, because you gave value (money) to the company and the company gave you an equal value (stock) back.

There was an exchange of value for value with no tax. But, exchanging value for value usually triggers a tax. When you give money to buy a house, and you get the deed to the house, that is value for value, but the seller owes taxes on the transaction. You can change one piece of real estate for another piece and not have to pay a tax, if you do a 1031 exchange. (I have a very comprehensive CD on 1031 exchanges titled *1031 and Out – This Isn't Your Mother's 1031.* As a newsletter subscriber, I will send you a free copy of the CD. Just call my office 801-802-9020, and talk to either Trent or Will and they'll get a copy out to you.)

The exchange of money for stock is a 351 exchange. Generally, you just ignore any "legal requirements" associated with the exchange. When you buy IBM stock, it is a 351 exchange, but you don't file any paperwork with the IRS.

However, if you are transferring a valuable asset into your company, such as a piece of real estate, make sure you issue yourself more stock in the company. You gave value (the real estate) and you need value (stock) back. If your amount of stock in the company doesn't go up after you put the real estate into the company, then it must not be a 351 exchange, and the IRS will look to see where the tax is going to be paid.

Usually, if you are putting a piece of real estate or a valuable asset into your company, you are worried about the asset protection issues. But, the tax issues can't be ignored. Moving assets of any type, including money, in and out of your little company has a tax consequence. If your company gets low on cash, what do you do?

Often, a small business owner will just transfer personal money into the company when the bank accounts get low. No more stock is issued. The infusion of money may be considered a loan, but there's no note issued. The "loan just goes on the books." This creates big problems when you get sued or the IRS audits the company.

Let's look at "stock" in your company. What's the "open market" value of stock in your small business? Basically, it is worthless. The only way your stock will ever be worth anything is when you sell the company or you "take the company public." The fact is most companies are never sold or put on the public market, so the stock is worthless forever.

I don't know what the statistic is, but the number of companies that open, operate for a period and then fail or just close down must be twenty times the number that are ever sold or go public. It is wise to plan for the most probable scenario for your company, not the pie in the sky scenario.

Maybe your company should be "funded" with a little cash for the original purchase of stock and then with debt. If you hold debt in your company, you have a huge advantage over just owning stock in your company. Make sure you do the paperwork for the stock and the debt – issue stock certificates for ownership and issue notes for debt.

If a business fails, the shareholders are in last position to get any of the spoils. On the other hand, debt holders are near the top of the list. To put yourself higher up on the list, go through the steps of collateralizing your debt. Make the company pledge specific assets to secure your debt and then go down to the local recorder's office and do a UCC (Uniform Commercial Code) filing on the debt.

You have to have a note, and it has to carry a reasonable interest. You may want to have a higher interest rate. A higher rate can be justi-

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FUND YOUR COMPANY WITH STOCK OR DEBT, CONT.

fied, because it is a high risk lending situation. If you pay interest, that comes out of your company as passive income, which isn't subject to employment taxes. This may save you more than 15% in taxes over taking the money out of your company as a wage.

You have to pay an interest rate, or the IRS has this funny habit of saying you didn't make the company a loan – you bought more stock. In fact, they will say it is a special class of stock. When they do that, your Subchapter S election will be voided (Subchapter S corporations only get one class of stock), and all of the "distributions" you have made can be reclassified as dividends subject to a double tax. The bottom line is PAY INTEREST.

Being able to take money out of your company without paying employment taxes is particularly important if you have a sole proprietorship or partnership.

The bottom line is financing your company with debt rather than stock purchases could be a lifesaver if the business fails, and the debt can give you some great tax advantages. ■

HOW TO AVOID A TAX AUDIT, CONT.

You can read all about how auditors are instructed to look for tax cheats in publicly available guides. They're not easy reading, but they will make the hair on your neck stand on end.

Want to avoid an audit? Here are some "red flags" that commonly draw the IRS' attention:

1. Math Errors --While an error in basic math might not instigate an audit, it's usually the most common reason Americans are audited. Use a calculator and check your numbers twice.

2. Unusually High Itemized Deductions -- The IRS uses a secret formula to calculate what your deductions should be. If a computer scan of your return shows that your deductions for charity, travel and entertainment, and healthcare are out of line with your income, you'll be on their radar. Lee travels a lot and we have been audited many times because his travel expenses are so high. We haven't had any problems because we have kept good records to prove the deductions.

3. Self-Employed/Schedule C Filers -- If you are a small business, the IRS suspects that you are being especially creative with your deductions, and they will audit you. Be careful if you take a home office deduction and have lost money for several years in a row. If you take a home office deduction, make certain you truly have space in your home dedicated solely for that purpose. Also keep excellent records.

4. Lots of 1099s -- In February 2010, in hopes of adding billions to depleted U.S. Treasury coffers, the IRS began a three-year initiative to crack down on what they believe to be a common practice of misclassifying employees as contractors. Six thousand businesses have already been targeted for audit, and the government hopes to hire 100 new Department of Labor employees specifically to police these abuses. And if they catch you, they will share their information with the IRS and State authorities. If you have 1099 employees, look in the *Accumulation and Preservation of Wealth* Business Planning section to be certain you are crossing all your T's and dotting all your I's.

5. Unreported Income -- Be especially careful to report all your income. If you've received a 1099, so has the IRS and their computers will notice if they don't match up. The same is true for other sources of income. If your former spouse reports alimony paid and you don't report receiving it, you've just painted a big bullseye on your tax return.

6. Previously Audited -- If you've been audited in the past, don't think you're off the hook, especially if you owed taxes or fines. The IRS knows people who have made mistakes in the past or have been overly creative will do it again. Don't have the mistaken impression that the auditor won't come knocking twice.

7. Small Business -- The IRS is greatly increasing the audits of small businesses. Some tax advisors have wondered if limited liability company income is more vulnerable to an audit, because it is reported on the owner's 1040 Schedule C. The audit figures don't prove it. When a small business corporation

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HOW TO AVOID A TAX AUDIT, CONT.

is audited, it frequently triggers audits of the shareholders (particularly if it is a one-owner business). If you are an investor in a partnership or corporation that was just audited, you may be next in line.

8. Made Someone Mad -- Disgruntled former employees are a regular source of IRS tips. But revenge isn't the only reason people go the IRS. The agency is authorized by law to pay rewards to informants. In cases that involve huge amounts of money, the informant's cut can be as high as 30% of what they collect. We have a client that made over a million dollars reporting an MLM guru that wasn't paying his fair share of taxes.

To put yourself in the best position to prevent an audit, consider the following ideas:

1. File an Extension -- Some tax advisors feel that if you file an extension, the audit pool will be full before they come to your return.

2. Be Organized -- Well organized records make it easier to prepare a tax return and help provide answers if your return is audited. Records such as receipts, canceled checks, and other documents that support an item of income or a deduction, or a credit appearing on a return must be kept for as long as they may become material to an audit, which generally is 3 years from the date you filed the return. Returns filed before the due date are treated as filed on the due date. However, there is no period of limitation to assess tax when a return is fraudulent or when no return is filed. If you are an employer, you must keep all your employment tax records for at least 4 years after the tax becomes due or is paid, whichever is later.

3. Hand Write Your Return – We have heard that handwritten returns are set aside and processed and are not as subject to the audit "lottery." You can still use software programs to calculate your taxes, just take a little extra time to hand write the amounts in the return. That would also mean that you may want to prepare your returns yourself rather than use an accountant.

Even if you do everything right, you can still expect to be audited some time in your life. When you receive a notice of audit, you may want to immediately hire a tax attorney or accountant experienced in IRS audits and tax controversies. Tax attorneys are experienced in fighting the IRS and directing the audit. An IRS audit is not fun. The auditor's job is to find mistakes and make money. They may keep looking until they find some of both.■