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From the Editor



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National Director
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This edition of the **HEIN & ASSOCIATES LLP Tax Advisor** focuses on some recent actions of the IRS, as well as some upcoming tax legislation which may affect the tax treatment of capital gains and dividends from 2008 to 2010. Congress could currently also recommend making some significant changes in the alternative minimum tax. Also of interest, a recent court decided whether a corporate payment is deductible by the corporation, or is a dividend. Under the law prior to 2003, the IRS wanted excessive salary treated as a dividend because the corporate payor could not deduct the dividend. We explore this further in this edition of the Tax Advisor. We hope that you find this information useful as you plan for 2006, and we urge you to call us with any questions or comments regarding this information.

Tax Legislation

As we go to press, Congress is considering important tax legislation before adjournment. Though it is unlikely we will have a massive tax bill, we may see some final legislation. Topics under consideration include an extension of the current tax treatment of capital gains and dividends from 2008 to 2010, and significant revisions in the alternative minimum tax. We will keep you informed of any meaningful changes that do occur this year. Also, we encourage your calls and questions at any time!

We may see much more activity in the tax legislative area next year. In November, the President's Tax Reform Panel issued a number of recommendations for amending the tax code. The panel focused on tax cheating. The panel concluded that dishonest taxpayers avoided \$280 billion in taxes by cheating. This revelation alarmed many in Congress. The Panel, and now Congress, is considering ways to find and collect some of these unpaid taxes. Considerations include greater scrutiny of small businesses and the way they report income. One suggestion required the use of special bank accounts by small businesses. Banks provide a summary of the activity in these accounts to the IRS to facilitate crosschecking of reported dollars.

Charitable giving is another area of major concern for the Panel. Some changes under consideration are:

- Increased reporting requirements for charitable donations.
- The use of an IRS table to calculate deduction amounts on in-kind gifts.

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IRS Activities

by **Ralph Kuhen, CPA**

Since our last newsletter, the IRS has been busy! They have issued the results of a number of studies, as well as several pronouncements that will have an immediate impact on all types of taxpayers. Please consider the following:

Tax Return Filing Extensions

In an attempt to avoid paperwork for both taxpayers and its own staff, the IRS recently indicated that it is granting individuals an automatic six-month extension for filing 2005 tax returns. Individuals, partnerships, and trusts who wish to extend their returns must file a Form 4868. There is no need to follow-up with the Form 2688 to gain an additional 2-month filing delay, as was required in the past. This change does not apply to corporations which will continue to file Form 7004 to gain a 6-month filing extension.

Examination Statistics

Individual taxpayer examination rates continue to slowly climb, according to the latest IRS statistics. The IRS states that 0.93% of personal returns were audited in fiscal 2005, up from 0.77% in 2004 and 0.65% in 2003. This 0.93% rate means that the IRS audits one out of every 108 tax returns. The IRS conducts most of these examinations by mail;—they are correspondence audits, which are limited-scope reviews of a particular issue. Face-to-face audits occurred only 0.19% of the time – equating to just one out of every 526 filed returns.

Tax Scam Warning

The IRS issued a consumer alert warning taxpayers about an Internet tax scam in which a bogus e-mail informs the recipient that he or she is eligible to receive a tax refund for a given amount. The fake email indicates that, in order to access a form to obtain the refund, the recipient must use a link contained in the email. The form asks for the individual's personal and financial information. The IRS emphasizes that it does not ask for personal identi-



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fying or financial information via unsolicited emails and individuals do not have to complete such a special form to obtain a refund. The IRS also warns against opening any attachments to the email since they may contain viruses, worms, etc.

Tax Shelter Settlement Initiative

The IRS published a settlement offer for thousands of tax shelter investors, including some promoters and related parties. The offer covers 21 types of shelters. It will permit interested parties to receive up to a 75% reduction in penalties, and allow them to deduct the actual dollars they have invested in the deal. This arrangement saves time and money for the IRS. It also saves a great deal of money for investors in many “flaky” investment schemes.

S Corporation Audit Program

The IRS is selecting 5,000 S corporations for “research” audits. The corporations will not be selected according to their risk of noncompliance with the tax laws. Rather, the IRS's goal is to learn more about S corporation behavior today. According to the IRS, the last time it undertook such a program was in 1984. Since that time, the law has changed significantly, and the number of S corporations has quadrupled.

Estimated Tax Payments

“Fall” into San Francisco Bay. The IRS announced that a traffic accident caused nearly 30,000 estimated tax payments to be dumped into San Francisco Bay. A truck carrying about 45,000 forms and tax payments overturned on the San Mateo Bridge on September 11, 2005. The IRS assured affected taxpayers that they would not be penalized. The payments were from 13 states, including Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Ohio, Oregon, Virginia, Utah, Washington, and Wyoming.

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Deductible Payment to a Business Owner Versus Dividend – A Change in the Equation

by Greg Dickey, CPA

A recent decision clarifies whether a corporate payment is deductible by the corporation, or is a dividend. Under the law prior to 2003, the IRS wanted excessive salary treated as a dividend because the corporate payor could not deduct the dividend. Therefore, tax liability would be increased at the corporate level, while it made little difference to the shareholder, since he or she reported ordinary income either as a dividend or as salary.

In the new case, the payment to the shareholder was made in 2000, and was listed as a royalty instead of salary. Whether a corporation calls a payment salary or something else, e.g., a royalty, the question under prior law is the same, “was the payment too high and should it have been categorized as a dividend?” In this case, the Tax Court agreed with the IRS that the inflated royalty was too high and that it should properly have been treated as a dividend.



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Under current law, the equation changes. Now that dividends are taxed to shareholders at no more than 15%, shareholders may benefit from a tax perspective if their compensation (the royalty in this case) is characterized as a dividend rather than some type of deductible payment by the corporation. In many cases, the income tax saved by the business owner on the dividend can exceed the additional tax paid at the corporate level when the payment is treated as nondeductible.

We haven't seen any cases on the issue yet, but we anticipate that IRS auditors will now start looking for cases where salary is unreasonably low. Also, the reduced rate on dividends is set to expire in 2008 (possibly to be extended to 2010), making planning to maximize tax savings very difficult.

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Other Items



by Alison Dunnebecke, CPA

Tenure buyout payments

Whether payments to tenured faculty in exchange for the relinquishment of tenure rights were wages for payroll tax purposes was an issue that was highlighted by a recent case. These payments were made by the University of Pittsburgh to induce tenured faculty members to accept an early-retirement program. The university had a number of faculty members accept the early-retirement program and originally treated the payments as FICA wages. The case arose because the university was alerted to the possibility that payroll taxes should not have been paid and filed a large claim for refund. The District Court held that because the payments “were made

in exchange for the relinquishment of ... contractual or constitutionally-protected tenure rights rather than as remuneration for services.” They were not subject to withholding and the university received a refund in excess of \$2,000,000. This case only applies to tenured faculty. It specifically does not apply to non-tenured faculty or university employees.

Standard mileage rates

The IRS has announced that the optional standard mileage rate has decreased four cents to 44.5 cents a mile for all business miles driven after 2005. This is down from the 48.5 cent rate that the IRS permitted for the last four months of 2005. The rate for computing deductible medical or moving expenses after 2005 is similarly reduced to 18 cents a mile from 22

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cents for the last four months of 2005.

Although the IRS normally updates the mileage rates once a year (in the fall for the next calendar year), the IRS increased the optional mileage rates for the last four months of 2005 by eight cents to reflect the huge jump in gasoline prices. Since gas prices have come down, the IRS has made this downward adjustment.

This adjustment may have an adverse impact for some employers who reimburse employees based on the standard mileage rate. If an employer reimburses employees based on the standard mileage rate, the reimbursement is treated as a tax-free accountable-plan reimbursement. However, if the employer reimburses at a rate higher than the standard mileage rate, the employee must report the excess as income. That excess is subject to payroll taxes. This may lead to a huge accounting headache for some employers!

Sales and Use Tax Agreement

On November 12, 2002 the 33-member states of the “Streamlined Sales Tax Implementing States” approved the Streamlined Sales and Use Tax Agreement (“Agreement”). Each state will be required to enact the Agreement into its own laws. The purpose of the Agreement is “to assist states as they administer a simpler and more uniform sales and use tax system.” On October 1, 2005 the “Streamlined Sales and Use Tax Agreement” came into effect with 18 states having seats on the Governing Board. A 19th state is scheduled to join at the beginning of 2006. These initial members of the Governing Board are the states whose legislatures have adopted the Agreement. Because of the myriad separate state and local jurisdictions currently levying some form of sales and use tax, state administrators felt that the project leading to the adoption of the Agreement is the only way to bring order and simplicity to this area. To become a member, a state is required to provide amnesty for the first 12 months preceding its participation in the Agreement. The amnesty applies to sellers that register with it under the Agreement (provided that a seller has not been contacted by the state for unpaid or uncollected sales or use tax). Participation in the Agreement is the trend for the future because all states are taking a hard look at the Agreement, and a number have begun the adoption process.

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