



Dr. Bart A. Basi is an attorney, CPA, and the President of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the *Financial, Legal & Tax Advisory* which may be read in various industry-specific trade publications.

THE TAX GAP

Introduction

Owners of closely held businesses enjoy many financial and tax advantages that general employees do not. Among the benefits, closely held business owners typically enjoy are superior incomes, the right to pick a successor, control over their business, increased net worth, and some additional tax deductions. Even though many benefits of business ownership are fair and legal, recently the "Tax Gap" created by illegal usage of deductions and understating of income has caught the attention of the IRS. In a Fact Sheet, the IRS has begun efforts to step up enforcement on small businesses and their owners who contort the tax rules.

Scope

The first step of any IRS enforcement effort is to conduct a survey to

understand the scope of the problem. The IRS has conducted a survey of 46,000 businesses. Its finding is that there is, in fact, a large "tax gap" between what small business owners pay and what they are obligated to report and pay under the law. The IRS has stated that the tax gap in the United States is approximately \$150 billion dollars annually among small business owners alone.

In a separate study, the California Franchise Tax Board has identified what types of businesses tend to have high non-compliance rates. Restaurants had a non-compliance rate of between 55-65 percent, used car dealers 45-55%, auto repair 40-50% and landscaping 35-45%. The survey however does not reveal what percentage of the "tax gap" exists due to willful noncompliance or ignorance of the law.

- Continued on page 2

A CASE STUDY

In a Tenth Circuit Court decision, it has been decided that the IRS can reclassify loans as compensation. The taxpayer in question borrowed millions of dollars and pledged stock in a business which he owned for the loans. When the loans came due, the owner did not have the funds available to pay off the loan due. To satisfy the loan obligation, he redeemed his pledged stock with his

corporation. Since the corporation was a flow through entity, he also tried to claim a bad debt on his own tax return. The IRS disallowed both of these actions, citing the substance over form doctrine declaring that the loans were really compensation since the company was responsible for paying the debt and he got the funds for his own benefit.

- Continued on page 3



The Center for Financial, Legal & Tax Planning, Inc.

The Fact Sheet

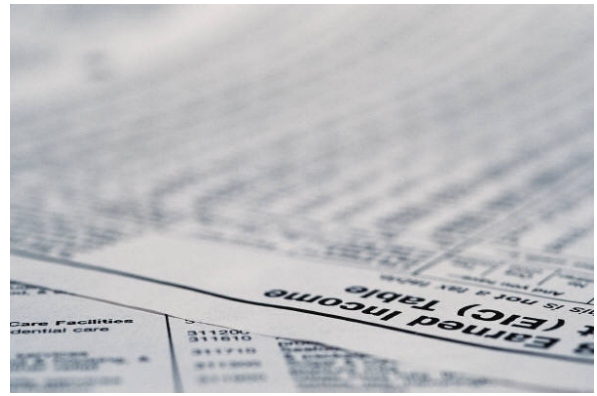
The first fact sheet, already published, addresses what makes up income. Simply stated, business owners must report ALL income received unless specifically excluded by law. In most cases this is received by check, cash, or credit. The letter further explains that other forms of income exist. Bartering, rent, interest, dividends, cancelled debts, promissory notes, damage awards, injury payments, and kickbacks (even though not necessarily received in cash, credit, or check) are also includible in income. The fact sheet also reveals the factors to determine costs of goods sold such as inventory, purchases, labor, materials, etc... The next fact sheet, not yet published, will discuss overstated expenses which also contribute to the tax gap.

The Impact

Increased IRS enforcement means more audits and assessments for offenders. Even though business owners may believe their books are in order to endure and withstand an audit, closely held business owners must be especially prepared for an audit. Many business owners do not have a set of corporate record books which have been updated to conform to IRS record keeping requirements. Lacking corporate record books can result in assets being includible in the business which should not be and possibly expenses which are allowed to be excluded and yet are not handled properly. Both of these consequences result in increased income and therefore more taxes payable.

Business financial records may be in need of review to make sure they are accurate and complete. Records beyond a certain number of years (depending on their nature and requirements) can be destroyed. If you have not been keeping financial or corporate records, such items can be updated or organized to meet compliance with some effort.

For some businesses, it may be wise to restate or amend tax returns for prior years to show a more accurate picture of their taxable income before the IRS comes in, conducts an audit and forces changes in the reported profits.



Conclusion

The “tax gap” is resulting in tougher enforcement efforts by the IRS. Owners of small and closely-held businesses need to be aware that the possibility for an audit or review to occur will be increased in the very near future. That is why it is currently imperative for business owners to update and review their records for compliance now. The Center routinely helps people deal with these matters. Contact us if you believe you need assistance or are not sure if you have a tax or financial compliance issue. Don’t hesitate as it can be a very costly mistake!

Points of Interest

- **Even though many benefits of business ownership are fair and legal, recently the “Tax Gap” created by illegal usage of deductions and understating of income has caught the attention of the IRS.**
- **The IRS has stated that the tax gap in the United States is approximately \$150 billion dollars annually among small business owners alone.**
- **The first fact sheet, already published, addresses what makes up income. Simply stated, business owners must report ALL income received unless specifically excluded by law.**

The Bradway Group—Tampa
1101 Channelside Drive, Suite 290
Tampa, FL 33602-3611

The Center For Financial, Legal & Tax Planning, Inc.
4501 W. DeYoung St., Suite 200
Marion, Illinois 62959

Editor's Comment: When a corporation redeems stock, the taxpayer must perform a test to determine whether the redemption is a distribution or a capital gain. The redemption must be one of economic and control substance. Control must be given up and there must be a substantial change in stock ownership. In this case, it is clear that the loan was income. Why the taxpayer brought this to trial is mysterious.

Remember, if your business is responsible for paying off a loan you made, and you receive funds as a benefit, the receipt of the funds must be taxed, either as a dividend distribution or a sale of your stock. Either way, you as the beneficiary of the funds, must pay taxes. The transaction is not a loan from the company since there is no intention on your part to repay it back to your company.



The Bradway Group—Palm Beach
824 US Highway 1, Suite 270
North Palm Beach, FL 33408



Avoiding the Common Pitfalls in Acquiring a Business

Rule #1: "If it ain't broke, don't fix it!"

Most buyers are eager to "make their mark" once they've acquired a business. But unless the business is losing money, or employees and customers alike despised the previous owner, it is generally a mistake for a new owner to make a lot of changes in the first 6 months.

Many times even small changes made with the best of intentions can have disastrous and unexpected consequences on employee morale and/or customer satisfaction, and ultimately on sales and cash flow. The risks are even greater if the previous owner was beloved by his employees & customers, as all eyes will be trained on you to see what waves you'll make -- presumed to be negative -- in this previous paradise.

If you're the new owner, most likely, you've just paid a substantial premium for the "goodwill" of this ongoing business. Respect this, and take the first few months to really get to know your employees and customers, who in reality are responsible for the business' continuing sales and cash flow. Get to know their true likes & dislikes about working in/buying from your business. Begin by making A FEW SMALL changes to remove their dislikes & reaffirm their likes, and then WATCH CAREFULLY how these changes affect employee morale, customer satisfaction, as well as top line & bottom line results.

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free consultation with us, have them contact me, or any of the M&A professionals at www.bradwaygroup.com.

Mike Ertel, CBI, M&AMI
The Bradway Group
813.299.7862 Direct
ertel@bradwaygroup.com

The Center For Financial, Legal & Tax Planning, Inc.
4501 W. DeYoung St., Suite 200
Marion, Illinois 62959

The Bradway Group—Palm Beach
824 US Highway 1, Suite 270
North Palm Beach, FL 33408
Phone: 561-776-8085
Fax: 561-776-1844

The Bradway Group—Tampa
1101 Channelside Drive, Suite 290
Tampa, FL 33602-3611
Phone: 813-864-6600
Fax: 813-864-6601

The Center For Financial, Legal & Tax Planning, Inc.
4501 W. DeYoung St., Suite 200
Marion, Illinois 62959
Phone: 618-997-3436
Fax: 618-997-8370

Satellite Office:
Longboat Key, FL 34228
Phone and Fax: 941-383-3338



We're on the Web!

www.taxplanning.com

www.bradwaygroup.com

Frequently Asked Questions...



Q: If I rename my company, must I pay federal taxes as though a sale had taken place?

A: Generally, no. Renaming a company is not a constructive sale of assets and does not or form give rise to capital or ordinary gain in most usual circumstances.

Q: Is an S Corporation required to make quarterly tax payments?

A: Yes. Subchapter S corporations must make estimated tax payments if the amount of taxes required to be paid exceeds the amount specified in the law. Taxes due from an S Corporation can arise from capital gains, passive activity, built in gains, and depreciation recapture.

Q: I am selling rental property which I have owned for many years. However, I have not taken a depreciation deduction for the property during the time I have owned it. What will my taxes be on this exchange?

A: When selling depreciable property, you are required to recapture and pay ordinary income taxes as required by law on depreciation taken or allowable. This means that even though you may have not claimed a depreciation deduction (thus paying higher taxes), you must still pay ordinary taxes to some extent in addition to the capital gains taxes due. To solve the dilemma, the IRS allows you to amend you tax return for up to 3 tax years. If you have not taken depreciation beyond 3 years, taxpayers can file for a change of accounting method to adjust for not taking depreciation on the rental asset.

If you no longer want to receive this e-mail publication, please send an e-mail to mail@bradwaygroup.com requesting to be removed from our mailing list.