



ARKANSAS SOCIETY OF • ACCOUNTANTS

RESPECTED ACCOUNTING PROFESSIONALS SERVING OUR COMMUNITIES

Monthly Newsletter

May 2007

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• FROM YOUR PRESIDENT'S PEN •



Dear Members,

It's good and only right to follow the laws of the land. However, sometimes I am at a loss as to the wisdom which stands (or hides) behind some laws. For instance, in Chicago, it's against the law to eat in a place that is on fire. In Macomb, Illinois, it's illegal for a car to impersonate a wolf. In Tennessee, it's illegal to drive a car while you're asleep. Brawley, California, passed a resolution banning snow within the city limits. An ordinance in San Francisco bans picking up used confetti to throw again.

Texas has one of the most confusing laws ever written. The law states, "When two trains meet at a railroad crossing, each must come to a full stop, and neither shall proceed until the other has gone." Talk about being asleep at the switch, the author of this bill must have had a lapse of wisdom. I can hear the conversation between two train drivers, "you go first." "No, you go first." And the conversation continues until the end of time.

Lately, I've been reading a lot about the Tax Gap. My understanding of the term Tax Gap is that it is the difference between the federal tax which should have been paid and the federal tax that was actually paid. My understanding of federal tax is any kind of federal tax. In a recent press release, Senate Committee on Finance Chairman, Senator Max Baucus, stated that

since 2001, the Government has failed to collect more than \$2 trillion in legally-owed taxes. His statement leads me to wonder if there is such a thing as illegally-owed taxes and how that occurs, but I digress. The \$2 trillion dollar figure caught my eye. How did Senator Baucus arrive at that amount? Surely if he knows the amount, he knows where the Tax Gap lies and who it is that creates the Gap.

The Tax Gap is big business! What drives such a thriving business? The first thought that comes to mind is that there are individuals who simply do not want to pay taxes. Some of those individuals use various tax-reduction techniques such as omitting income earned and increasing deductions not actually paid when preparing their returns. These taxpayers appear to be dishonest. To be sure, many are dishonest. But some are simply ignorant (unaware, uninformed, etc.) as to what the tax law really is. Every filing season we hear one or more client make the statement, "I sold some land this past year, but then I bought another piece of land within a year, so the gain from the sale is not taxable." They're relying on a law that hasn't been on the books for decades. We can think of other instances where taxpayers rely on hear-say, advice from a brother-in-law, and personal returns filed decades ago. There are many taxpayers who prepare their own return who simply are unaware of tax law that may affect their return. Back to illegally-owed taxes. Many of these self-prepared tax returns fail to take all of the deductions and credits available to them. I wonder if Senator Baucus

remembered to deduct the illegally-owed taxes from the legally-owed taxes when calculating \$2 trillion dollars.

Perhaps one of the driving forces behind the Tax Gap is simply the complexity of tax law. Remember those two Texas train drivers. Indecision and confusion may cause noncompliance. Perhaps, Senator Baucus along with other legislators will want to admit to responsibility in creating the Tax Gap. I suspect there were a lot of illegally-owed taxes paid during the recent tax filing season due to late-passed tax law that did not afford the Internal Revenue Service to include adequate lines on tax forms to provide adequate reporting for these items.

Regardless of the reasons for the Tax Gap, it is big business (bigger than Wal-Mart), and it is probably here to stay. Where do we fit in with regard to the Tax Gap? Several statements made by Senator Baucus in his press release give an indication. First, he states, "Some complain that improving tax compliance will burden taxpayers and decrease their rights. But what about the rights of honest, hard-working taxpayers who do pay the taxes they owe? What about the burden on honest taxpayers when the dishonest are allowed to skate by?" This statement leads me to believe that Senator Baucus believes that the Tax Gap is caused by dishonest taxpayers. I suspect he is interested in increased tax return audits. You know where that puts us. His statement made no provision for honest taxpayers who are confused and uninformed, nor does it make any provision for returning illegally-owed taxes to taxpayers.

Next Senator Baucus states, "Increasing our nation's rate of voluntary tax compliance is going to take some ingenuity. It will take some elbow grease. It is going to require a multi-faceted approach. It will require addressing services, enforcement, and technology." This is a high sounding statement, but who knows what it means or where it will lead? Remember those two Texas train drivers.

Ronny Woods P.A.
President

LETTER TO PRESIDENT OF
ARKANSAS STATE BOARD OF
PUBLIC ACCOUNTANCY FROM
IRS

March 14, 2007

Sherry H. Stringer, CPA, President
Arkansas State Board of Public
Accountancy
101 E. Capitol, Suite 450
Little Rock, AR 72201

Dear Ms. Stringer:

The purpose of this letter is to inform you of a determination we have made concerning the eligibility of Arkansas Public Accountants to represent taxpayers before the Internal Revenue Service. Under the provisions of Treasury Circular 230, a "Certified Public Accountant" is a person who is duly qualified to practice as a certified public accountant in any State, territory or possession of the United States. Certified Public Accountants who are not currently under suspension or disbarment from practice before the IRS may practice before the IRS. As a result of a determination by the IRS Chief Counsel that some Public Accountants may be eligible to practice before the IRS, we are conducting a comprehensive State-by-State review of this issue.

In October 2004, a Chief Counsel memorandum addressed the eligibility to practice before the IRS of Pennsylvania Public Accountants who were licensed before a change in the law governing the practice of accountancy in that State. The Chief Counsel concluded that Pennsylvania law accorded these Pennsylvania Public

Accountants the same practice privileges as Pennsylvania Certified Public Accountants, provided they meet the same ethical and continuing professional education requirements as Pennsylvania Certified Public Accountants. As a result, Pennsylvania Public Accountants were found to be eligible to represent taxpayers before the IRS, in the same manner and subject to the same restrictions as Pennsylvania Certified Public Accountants.

After a careful review of Arkansas law governing the practice of accountancy, we have concluded that Arkansas Public Accountants, like their counterparts in Pennsylvania, have the same practice privileges as Arkansas Certified Public Accountants. This means that Arkansas Public Accountants may practice before the IRS, under the provisions of Treasury Circular 230. We will inform IRS personnel of our conclusion, so that they will recognize Arkansas Public Accountants as authorized representatives before the IRS.

If you should have any questions, please call Mike Hahn of my staff at (202) 622-6750.

Sincerely,

Michael R. Chesman
Director, Office of Professional
Responsibility

SMALL CASE DOLLAR LIMIT
QUESTIONED

The small case division of the Tax Court hears cases using simplified rules and without requiring the taxpayer to use an attorney.

A “small case” generally is one involving no more than \$50,000 of tax per year. Thus, if a case involves three years, it can involve up to \$150,000 of tax.

New Case: A dispute involved IRS collection actions regarding taxes owed for seven years. The maximum tax for any one year was \$37,000, and the total tax for all years was \$158,000. Because no one year’s tax exceeded \$50,000, the taxpayer asked to have the case heard by the small case division, the IRS agreed, and a small case trial was held.

But after the trial, before rendering a decision, the Tax Court itself objected to the small case proceeding.

Court’s ruling: The Tax Code states that in small cases where the amount of a tax deficiency is disputed, the amount at issue can be up to \$50,000 per year.

But when Congress amended the Tax Code to allow the small case division to hear disputes about IRS collection actions – with the amount of tax involved not disputed—it set the dollar limit on the tax involved at \$50,000 period.

Because this case involved a collection action regarding tax exceeding \$50,000, it is not eligible to be heard by the small case division. The case must be moved to the regular Tax Court. T.C. Schwartz, 128 TC No. 2.

ALL ABOUT LLCs **THE PLAIN TRUTH** **WHAT THEY CAN DO** **AND CAN'T DO**

Limited liability companies (LLCs) are a popular form of business organization. They have been referred to as hybrids because they offer the same personal liability protection as corporations but with the pass-through tax treatment of partnerships. First endorsed by the IRS 20 years ago, they remain the new kid on the entity block, with several issues still unresolved and many aspects misperceived. The plain truth about LLCs....

■ LLCs don't save taxes. There is not "magic" federal tax savings from operating as an LLC. (Of course, you do avoid the double taxation inherent with C corporations.) Although the LLC is not itself a taxpayer, its owners (members) must report their share of LLC income, gains, deductions, credits, etc. on their personal returns. If there are two or more members, the LLC files a partnership return and allocates these items to owners on Schedule K-1. If there is a single member, LLC items are reported the member's Schedule C of Form 1040.

Using an LLC does not save state taxes either. Example: Owners based in California cannot avoid the California gross receipts tax by forming an LLC in Delaware (or any other state) if they do business in California. This is true

even when they buy property in Oregon through an LLC formed in Oregon. Managing property from California subjects the LLC to California's gross tax receipts tax.

LLCs formed in another state must register to do business in the state in which they operate. Failure to do so may mean there's no personal liability protection for owners in the state in which they run the business.

■ LLCs are useful for estate planning. This is due to the ease with which funds can be transferred from one generation to the next. For instance, say a parent owns an LLC holding real estate and wants to transfer some or all of this to his two children on a tax-favored basis. Using the annual gift tax exclusion (\$12,000 per recipient in 2007), he makes gifts of interests in the LLC to them each year with no transfer tax cost. The value of these interests for gift tax purposes is less than the allocable value of the underlying assets, effectively allowing more to be transferred tax free.

Example: A rental property, valued at \$2 million, is held by an LLC owned by the parent. Applying a valuation discount of 40% because the interests given to the children are minority interests and are not marketable, the parent can transfer, tax free, \$12,000 worth of property to each child—which actually represents \$20,000 worth each. This can be repeated annually until the parent has transferred the desired share of the LLC.

Transferring interests to children during life can mean that when the parent dies, his remaining interest qualify for valuation discounts in his estate, making his estate worth less. (A discount for minority interests applies if the parent has transferred enough of the LLC to his children to bring his remaining ownership interest below 50%.) A “marketability” discount also applies.

For estate planning purposes, the LLC is superior to the S corporation because...

- An LLC can make disproportionate distributions to the parent and children, allowing the parent to receive income from the business to whatever extent desired (assuming the company is profitable enough to pay and provided a complex set of rules followed) throughout his life or to give children a greater share of income. The children’s share of income isn’t viewed as a gift from the parent (but they are taxed on income they receive). An S corporation must make proportionate distributions to shareholders – disproportionate distributions can result in termination of S corporation status.
- The parent can retain control over the LLC throughout his lifetime by classifying the children as non-managing members – this bars them from having a say in day-to-day operations. This approach cannot be used in an S corporation because different classes of stock are not allowed.

- Heirs receive a stepped up basis in the assets of the LLC, allowing them to claim greater depreciation deductions because new depreciation deductions will be based on the inherited property’s current fair market value. There’s no basis step-up for assets held by an S corporation.

■ LLCs don’t make it easy for owners tax-wise. The member pays tax on his portion of the LLC’s income, regardless of what’s actually distributed to him. Because a member is viewed as self-employed, he can’t receive wages from the LLC. A member can’t pay income taxes through payroll withholding and must file quarterly estimated tax payments.

Health insurance can’t be provided to a member on a tax-free basis. If the LLC pays the premiums, the amount is treated as a guaranteed payment to the member, increasing the distributive share picked up as income by the member. The member can, however, deduct 100% of the LLC-paid premiums as an adjustment to income on his personal return if he is otherwise qualified.

As yet, there’s no definitive guidance on whether and to what extent an LLC member is subject to self-employment tax. Experts agree that a member who’s a manager of the LLC is treated like a general partner, who is subject to self-employment tax on his distributive share. However, limited partners generally are exempt from self-employment tax.

Impact: Partners who are non-managers

may be treated like limited partners, escaping self-employment tax on some, if not all, of their share of net income from the LLC.

Underground economy target.

Tipped restaurant employees. The IRS has been encouraging restaurant owners to sign up for the Attributed Tip Income Program (ATIP). How it works: The employer uses a formula based on its prior year credit card tip rate. Employees are supposed to report cash tips but many do not. An assumption is made that the tip rate for cash sales is 2% less than the charged tip rate. These rates are applied against the restaurant’s gross sales to determine the amount of tips that should have been reported. Catch: Employees will resent paying tax on credit card tips based on the prior year if current charged tips are running at a lower rate. Possible solution: The employer should report actual charged tips on W-2 forms and use the 2% “approved discount

IRS loses. Unwed father gets tax benefits for children.

An individual had three children with a woman he was neither married to nor lived with. He claimed dependency exemptions for them along with head of household filing status and the earned income and child tax credits. But the mother claimed the children as

dependents, too, and the IRS disallowed his claims. Tax Court: The evidence showed that the children lived with their father for seven months of the year and their mother for five. Because he had custody for the longer period, he gets the exemptions, and the exemptions entitle him to the tax credits. Because he provided a household for them for more than half the year, he gets the head of household filing status too.

Ishmael Tarukh, TC Summary Opinion 2007-12.

What’s a Used Coat Really Worth

When donating used clothing and household items to charity, how can you fix a value?

It’s up to the contributor to figure it out. Useful resource: The Salvation Army’s “Valuation Guide” at www.satruck.com/VakueGuide.aspx provides suggested values for items ranging from air conditioners and bathrobes to TVs and underwear – both with a low and a high figure.

Caution: Only items in good condition or better are deductible, so it’s a good idea to take a photo to prove this (keep the photo with tax records for the year of donation).

Note: A single item valued at more than \$500 is deductible even if in lesser condition, as long as it’s been appraised and the appraisal is attached to the return.



**APPLICATION FOR MEMBERSHIP IN
THE ARKANSAS SOCIETY OF
ACCOUNTANTS**

P.O. Box 725
Newport, Arkansas 72112
laverne1@cox-internet.com
www.arspa.org

Last Name _____ First Name _____ Middle Initial _____ Business Phone _____ Home Phone _____

Business Address _____

How many years of accounting have you had? _____ Date of Birth _____

Sole Practitioner [] Partner [] Employee [] Corporate Officer []

Name of Firm _____ Number of Employees _____

Name of Partner(s) _____

Are you a Licensed, Registered or Certified Public Accountant? _____ If yes, give License# _____

Are you an Accredited Public Accountant? _____ If yes, give Accreditation # _____

Are you an Enrolled Agent _____ If yes, give EA # _____

Do you hold an Associate or Baccalaureate degree with a minimum of 24 semester hours in Accounting? Yes _____ No _____

Are you engaged in any other trade or profession? _____ If yes, please describe _____

Please list other accounting organizations in which you hold membership: _____

I hereby state that the accompanying statements are correct to the best of my knowledge and belief. I further state that I will abide by the Constitution and By-Laws of the Society and will practice in strict conformity with the Code of Ethics and Rules of Professional conduct adopted by the Society.

Date _____ Signature of applicant _____

Annual dues are payable IN FULL in advance and are prorated for credit by ASPA on a monthly basis to August 31 - the end of ASPA's fiscal year.

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