

Arkansas Public Accountant

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May 2004

• **FROM YOUR**
PRESIDENT'S PEN •



Dear Members:

Last fall President Elect, Tom Simmons, addressed a very important issue in an article he wrote for our monthly newsletter. The issue was about preparing this society for the future by proposing a name change for our organization. An issue that I presently support.

Once upon a time the ARKANSAS SOCIETY OF PUBLIC ACCOUNTANTS was predominantly made up of one group of members, and that group was public accountants. A group whose purpose was, and still is to serve the interest of their clients and the general public. While we still have some of that original group of public accountants, their numbers have diminished and been replaced by others.

The designations of our membership has changed vastly over the years and become more diverse. Our members are PA's, CPA's, EA's, ABA's, CVA,s with BA's and MBA's and many other designations too numerous to list.

Our society is not unique in proposing a new name for its organization. The National Society of Accountants, NSA, was once the National Society of Public Accountants. I will admit that removing NSPA from my vocabulary took awhile. But now I can say NSA will be the best of them. Change is never easy. But once in a while we must change to have the opportunity to move forward.

Our future as a society will be determined by whether we are able to attract CPAs, young or old. There will be no new PAs. The designation PA is a dying breed. I have heard that statement ever since I joined this society. So looking forward is looking for ways to attract new members,

Topics Covered in this Newsletter

IRS WARNS BUSINESSES, INDIVIDUALS TO WATCH FOR QUESTIONABLE EMPLOYMENT TAX PRACTICES

ABUSIVE TRUST TAX AVOIDANCE SCHEMES

BUSINESSES SHOULD CONSIDER FILING "PROTECTIVE" REFUND CLAIMS

namely CPAs. Accountants have joined our society because of its continuing education seminars and the emphasis on support for the small practitioner. We need to make this society more attractive to others not only for membership but for participation. In order to be more attractive to more CPAs, we are proposing changing the name to one that does not single out anyone specifically. The ARKANSAS SOCIETY OF ACCOUNTANTS is one option that has been mentioned.

The Board members and I would like your feedback on this issue. We, the members of the Board, cannot change the name. The “membership” in attendance at the Annual Convention in September will be the ones voting on this issue. I invite your input and support for the future of our society.

Next month we will have a one day Estates and Trusts seminar in Little Rock. I look forward to seeing you there and hearing your thoughts and concerns for our society’s future.

Sincerely,
Brian Thompson, CPA
President, ASPA

**Tax Information from the IRS
Provided by SB/SE Taxpayer Education
and Communication Little Rock, AR**

**IRS Warns Businesses, Individuals to
Watch for Questionable Employment
Tax Practices**

The Internal Revenue Service issued a consumer alert for eight schemes where federal employment taxes are not properly withheld or paid by

employers from their employees’ paychecks. The IRS alert to business owners and other taxpayers follows a string of recent convictions and court rulings involving employment tax schemes.

“Failure to pay employment taxes is stealing from the employees of the business,” said IRS Commissioner Mark W. Everson. “The IRS pursues business owners who don’t follow the law, and those who embrace these schemes face civil or criminal sanctions.” There are many reasons employers don’t withhold or pay employment taxes. For some, it may be an attempt to use the government as a bank to ‘borrow the money for a short while’ with good intentions to pay it back later. For others, it may be a situation where an employer collects the taxes and elects to keep it during a period of financial difficulty rather than pay it to the IRS. For a small number, it involves philosophical differences with the tax law of the United States that courts consistently reject. Regardless of the reason, federal law requires employment tax withholding and payment by employers.

Employment taxes consist of federal income tax withholding along with Social Security and Medicare taxes and unemployment taxes. Also, many states have withholding requirements for various employment related taxes, such as contributions to a worker’s compensation fund. Improper reporting or payment of employment taxes affects the ease with which employees can claim future benefits from these programs.

The IRS takes a variety of steps to combat employment tax non-compliance. The agency has a number of civil actions it can take like audits and filing tax liens against property the taxpayer owns. In addition to civil actions, IRS Criminal Investigation investigates and refers for prosecution individuals and businesses that

have willfully attempted to avoid filing and paying employment taxes. These efforts have led to significant criminal convictions resulting in incarceration and fines.

During the past three years, 117 individuals have been sentenced to confinement in a federal prison, a halfway house or home detention for criminal violations related to employment taxes. Approximately 77 percent of the persons sentenced for evading employment taxes served an average of 17 months confinement and were ordered to make restitution to the government for the taxes evaded, plus interest and penalties.

Recent examples of employment tax prosecutions can be found at [IRS.gov](https://www.irs.gov). See the link for Significant Employment Tax Case Summaries, below. The IRS urges all businesses to resist the temptation to become involved in or victimized by unlawful activities. The eight most common types of employment tax non-compliance include:

1. Pyramiding. “Pyramiding” of employment taxes is a fraudulent practice where a business withholds taxes from its employees but intentionally fails to remit them to the IRS. An often cause is a lack of profit or capital for operating costs, so the business owner uses the trust funds to pay other liabilities. The quarterly employment tax liabilities accumulate (or “pyramid”) until the employer has little hope of catching up. Businesses involved in pyramiding frequently shut down or file for bankruptcy and then start a new business under a different name starting the cycle over.

2. Unreliable Third Party Payers. There are two primary categories of third party payers – Payroll Service Providers and Professional Employer Organizations. Payroll Service Pro-

viders typically perform services for employers such as filing employment tax returns and making employment tax payments. Professional Employer Organizations offer employee leasing meaning that they handle administrative, personnel, and payroll accounting functions for employees who have been leased to other companies that use their services. Many of these companies provide outstanding services to employers. Unfortunately, in some instances, companies of both types of services have failed to pay over to the IRS the collected employment taxes. When these employment service companies dissolve, millions in employment taxes can be left unpaid. Employers are urged to exercise due diligence in selecting and monitoring a third party payer. For example, when choosing a third party payer, employers should look for one that is reputable and uses the Electronic Federal Tax Payment System (EFTPS). This allows the business owner to verify payments made on their behalf. Also, an employer should never allow their address of record with the IRS be changed to that of the third party payer.

3. Frivolous Arguments. Unscrupulous individuals and promoters have used a variety of false or misleading arguments for not paying employment taxes. These schemes are based on an incorrect interpretation of “Section 861” and other parts of the tax law and have been refuted in court. One variation of this scheme involves the improper use of Form 941c, Supporting Statement to Correct Information on Form 941, to attempt to get a refund of previously paid employment taxes. Recent court cases have resulted in criminal convictions of promoters. Employer participants could also be held responsible for back payments of employment taxes, plus penalties and interest.

4. Offshore Employee Leasing. This scheme, which was designated as a Listed Transaction by the Service in 2003, misuses the otherwise legal business practice of employee leasing. Under the typical promotion, an individual taxpayer supposedly resigns from his or her current employer or professional corporation and signs an employment contract with an offshore employee leasing company. The offshore company indirectly leases the individual's services back to the original employer using a domestic leasing company as an intermediary. The individual performs the same services before and after entering into the leasing arrangement. While the total amount paid for the individual's services stays the same or increases, most of the funds are sent offshore as "deferred" compensation. The "deferred" compensation is then paid to the individual as a "loan" or ends up in an account under the individual's control. Promoters of these arrangements improperly claim that neither employment taxes nor income taxes are owed on the "deferred" compensation. Because it is a Listed Transaction those who use the scheme are required to disclose their participation on current tax returns, and will be liable for the unpaid tax and subject to penalties and interest. Civil and criminal actions are being taken against promoters and participants in offshore leasing schemes – one promoter was convicted of defrauding the U.S. and sentenced to 70 months imprisonment, two other promoters have been ordered by the courts to stop marketing the scheme and a San Diego doctor plead guilty to tax evasion and are awaiting sentencing.

5. Misclassifying worker status. Sometimes employers incorrectly treat employees as independent contractors to avoid paying employment taxes. Generally if the payer has the right to control what work will be done and how it will be done, the worker is an employee. Employ-

ers who misclassify employees as independent contractors and are not eligible for relief under Section 530 of the Revenue Act of 1978, will be liable for the employment taxes on wages paid to the misclassified worker and subject to penalties.

6. Paying Employees in Cash. Paying employees in whole or partially in cash is a common method of evading income and employment taxes. There is nothing wrong with compensating an employee in cash, but employment taxes are owed regardless of how the employees are paid. And the IRS will build its case using all available information even if there are no payroll records or checks.

7. Filing False Payroll Tax Returns or Failing to File Payroll Tax Returns. Preparing false payroll tax returns intentionally understating the amount of wages on which taxes are owed or failing to file employment tax returns are methods commonly used to evade employment taxes.

8. S Corporation Officers Compensation Treated as Corporate Distributions. In an effort to avoid employment taxes, some S Corporations are improperly treating officer compensation as a corporate distribution instead of wages or salary. By law, officers are employees of the corporation for employment tax purposes and compensation they receive for their services is subject to employment taxes.

The IRS encourages employees to report any concerns that an employer is failing to properly withhold and pay federal income and employment taxes. Taxpayers can contact the IRS at 1-800-829-1040 or report suspected tax fraud by calling 1-800-829-0433.

Employers must report employment taxes

withheld from their employees on Form 941, Employer's Quarterly Federal Tax Return. Employers are also responsible for filing Form 940, Employer's Annual Federal Unemployment Tax Return. Payment of employment taxes must be made to an authorized bank or financial institution according to federal tax deposit requirements. Employers may also pay these taxes electronically.

Abusive Trust Tax Avoidance Schemes

The Internal Revenue Service is cautioning the small business community and public in general about schemes that create "sham" trusts in an attempt to evade federal taxes. In the last few years the IRS has detected a proliferation of abusive trust tax avoidance schemes. Since October of 2001, the courts have issued 19 permanent and 2 preliminary injunctions against promoters of these abusive trusts.

Generally, a trust is a form of ownership that separates responsibility and control of assets from the benefits of ownership. Sham trusts deliberately hide the true ownership and control of the trust assets and income in order to avoid correct federal taxation rules.

In abusive trust schemes, bogus or inflated expenses are often charged against trust income. After the deduction of these expenses, the remaining income is distributed to another trust, and the process is repeated. The result of the distributions and deductions is a decrease in the amount of income ultimately reported to the IRS.

These schemes may be promoted with domestic components, offshore components, or a combination of the two. Often, the trusts involved in

the scheme, whether foreign or domestic, are vertically layered with each entry distributing income to another layer. Nondeductible or bogus expenses are often charged against the income throughout the layers. No economic purpose or substantial change in the economic relationship is present, although they give the appearance the taxpayer or small business has given up control of the assets when in reality they have not. The result of these arrangements is intended to substantially reduce the amount of income reported to the IRS.

Taxpayers and/or small business owners should be aware that abusive trust arrangements will not produce the tax benefits advertised by their promoters and that the Internal Revenue Service is actively examining these types of trust arrangements. Furthermore, taxpayers, small businesses and/or the promoters of these trust arrangements may be subject to civil and/or criminal penalties.

For further information, visit the Criminal Investigation web site at: <http://www.irs.gov/irs/content/0,,id=106057,00.html> or the IRS web site at: www.irs.gov

If you have specific questions on a tax scheme or wish to report a possible scheme, call 1-866-775-7474 or send an e-mail to: www.irs.tax.shelter.hotline@irs.gov

If you need additional information related to the above topics, please contact the local Taxpayer Education and Communication office at 501-342-5328 ext.276

Businesses should consider filing "protective" refund claims for illegally collected telephone tax.

Office Max has just won a \$380,000 refund of telephone tax in federal court. The total of such refunds could reach \$6 billion.

As this publication reported in our March 2004 publication, the Tax Code puts a tax on long-distance calls billed by “time and distance.” But, through the phone companies, the IRS taxes all long-distance calls, including service not billed on both time and distance. The Office Max case says such tax is refundable, though another recent federal case says it isn’t.

File refund claims now for three years back to keep claims from expiring, but don’t expect the IRS to act on them until the dispute is settled.

Shareholders in S corporations can be considered employees by the IRS. It’s not unusual for the owner of an S corporation not to pay himself/herself a salary in order to save payroll taxes.

A profit recognized by an S corporation is not subject to Social Security taxes.

A number of years ago, the Internal Revenue Service began to target S corporations that did not pay their sold shareholder a reasonable salary. Some of these cases are now being decided by the US Court of Appeals in favor of the Internal Revenue Service. **Most recent decision:** Superior Proside, Inc., in the Third Circuit Court of Appeals {January 28, 2004},

held that the S corporation had failed to support its claim that it lacked control of its shareholder and did not adequately support its position that the shareholder was not an employee.

SUVs and Section 179 Expensing

The biggest vehicle-purchase break in the new law is the Section 179 expensing election for sport-utility vehicles [SUVs].

A taxpayer may elect to deduct equipment purchases immediately rather than depreciate them over a period of years. The new limit is \$100,000 for 2003 and \$102,000 for 2004, increased from \$24,000 in prior years.

Vehicles weighing more than 6,000 pounds are not considered “passenger automobiles” according to the Tax Code, so the annual depreciation limits that apply to automobiles do not apply to them. They can be depreciated or expensed like any other business equipment.

When an SUV is purchased, the Section 179 election can be used to deduct its entire cost immediately.

It is rumored that Congress may close this loophole soon.

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FOR YOUR INFORMATION

The ARKANSAS PUBLIC ACCOUNTANT is the monthly publication of the ARKANSAS SOCIETY OF PUBLIC ACCOUNTANTS. We are a professional organization dedicated to the promotion of accountants and tax preparers in the State of Arkansas. We accept newsworthy articles and advertising. If you have either of these for publication, please contact the editor.

LaVerne Long, ED
P O Box 725
Newport, AR 72112 - 0725
Email: longaspa@cox-internet.com
Phone: 870-523-5329
Fax: 870-217-0154