



# ARKANSAS SOCIETY OF • ACCOUNTANTS

RESPECTED ACCOUNTING PROFESSIONALS SERVING OUR COMMUNITIES

## Monthly Newsletter

June 2008

2007 Audit Numbers

When the IRS rejects your offer

Relying on a FLP to reduce estate tax

Proving Unreported Income

### • FROM YOUR PRESIDENT'S PEN •



Dear Members

I love sports. My favorite sport to watch is professional football. My favorite sports to play are golf and basketball. The most exciting sport in my life right now is machine pitch baseball, because that is the sport that Hank is playing. He's 8 years old. This is serious business.....for some of the players. Others are more interested in building sand castles in the edge of the outfield. Some players are making diving plays and throwing kids out. Others are throwing their glove for no particular reason to no particular person, during the middle of the inning. My Hank is one of the intense players. He is into the game. He plays right by the pitching machine and he's always catching line drives coming at his head. In his last game, he recorded every out in the field that was not a strikeout. I'm a little proud, but don't tell him because I don't want his head to swell. I've included a picture of last year's all-star team, who were district champs and state runners-up. Hank is the smallest person in the photograph.

I couldn't imagine if one day we went to the ballpark and the game was being umpired by my grandma. I love my grandma. She's a wonderful person. Unfortunately, some might have a minor quibble about the fact that she doesn't know the first thing about baseball. I'm sure her intentions would be good. For example, I bet she would feel compassion for that little kid who never gets on base and just award him first base because he's such a "fine, young gentleman." Her reasons for being there might make sense as well. The prior umpire may have understood the game and the rules, but he was 2 minutes late last week. I can assure you that grandma has never been late. My grandma is one of the greatest people I know, but I don't want her deciding what happens on the diamond.

Did you know that the Department of Finance and Administration is currently working with the Division of Legislative Audit to provide alternatives to change the current organizational structure for most of the Boards and Commissions in the State, which includes the Arkansas Board of Public Accountancy? Their reasons

make sense, those being to better safeguard state assets and provide cost savings. I'm sure reasons for getting my grandma to umpire could make sense as well. She probably wouldn't charge a dime to call the game and she'd make all the kids and parents an apple pie "just for trying." Just like I couldn't imagine grandma calling the game, I couldn't imagine the current organizational structure of the State Accounting Board being changed. Our profession is a technical profession that requires both knowledge and experience for oversight. I may not like getting letters from the board for Quality Review or CPE audits, but I do like the fact that I know that those who are reviewing my information understand the accounting profession and the issues that I am dealing with. I know several people who serve on this board, so I know how hard they work to regulate our profession in Arkansas. I don't want this to change. There may be some boards and commissions in the state that could use some changes, but I don't think our board is one of them.

Brad Crain, C.P.A.  
President

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## THE 2007 AUDIT NUMBERS ARE IN HERE ARE THE HOTTEST TARGETS

Just released figures for 2007 show that the IRS audit rate is slowly rising overall, but remains very low by historical standards.

Moreover, audit rates often are very uneven. For instance, a home office is much less likely to be audited when a family business is organized as an S corporation than as a proprietorship.

Here's information that can help you manage audit risks for our clients.

### TOP AUDIT TARGET

The IRS's top audit targets today are small businesses, since it considers the single biggest component of the "tax gap" (the amount by which taxes are underpaid) to be "business income on individual returns." The IRS estimates this part of the tax gap to be \$148 billion, or fully 43% of the total tax gap of \$345 billion.

But small businesses organized in different ways have very different levels of audit risk.

Proprietorships, S corporations, and partnerships all report their income on their owners' individual returns. Yet the audit rate for proprietorships is far higher than for the other forms of businesses.

In 2007, proprietorships, which report their income on Schedule c of their owner's returns, had high audit rates that varied with total gross receipts to these levels....

- Total gross receipts of less than \$25,000 – audit rate of 1.3%.
- \$25,000 to less than \$100,000- 2%.
- \$100,000 to less than \$200,000 – 6.2%.
- \$200,000 or more – 1.9%.

In contrast, all S corporations were audited at only a 0.5% rate, and all partnerships at only a 0.4% rate – just a fraction of the lowest audit rate incurred by the smallest proprietorships. (The audit rates for S corporations and partnerships are based on assets and not on income level.

**Planning:** Organizing a small business as an S corporation or limited liability company (LLC) partnership retains the advantages of reporting the firm’s income on your own tax return -- such as avoiding extra corporate-level tax on profits and being able to deduct the business’s losses personally. However, it can also provide additional valuable legal and tax benefits. Examples:

- Personal protection against legal liability for claims of creditors of the business is provided by an S corporation or LLC that is taxed as a partnership. (An S corporation may have only one owner, as a proprietorship does.)
- Employment taxes may be reduced, since all income earned by a proprietorship is subject to employment tax (at a rate of 15.3% against up to \$102,000 in 2008, and at 2.9% -- for Medicare – on all income above that level). But only wages paid by an S corporation are subject to employment tax – corporate profits are not. Similarly, LLC members may avoid employment tax under certain circumstances (under complex tax rules).

- An S corporation or partnership can have other owners while the creator retains management control – generating the ability to shift income to lower-tax-bracket family members, reducing future estate taxes.

So there are sound business and tax reasons to convert a proprietorship to an S corporation, partnership, or LLC.

Sharply reducing audit risk is another one.

**Risk-reducing bonus:** Owning an S corporation or partnership rather than a proprietorship not only reduces the risk that the business return itself will be audited, but can also reduce the risk that particular deductions will draw an auditor’s attention.

**Example:** Many tax-experts believe that the home office deduction is a “red flag” to IRS auditors. To take this deduction on a proprietorship’s Schedule C, you attach form 8829 – which announces the deduction to the IRS. But if you work in a home office for your S corporation, you don’t take this deduction. Instead, you obtain reimbursement for your office’s costs from the firm under an “accountable plan,” and the firm deducts the reimbursement. There is no Form 8829 filed.

Deductions for other items may similarly be less exposed to audit risk when taken through an S corporation or partnership.

Examples: Personally owned computers, portable phones, and other electronic equipment used outside of a home office are subject to stringent technical deduction rules that an auditor may apply when deducted on a Schedule C. When the same equipment

is owned and provided an S corporation, its “audit risk profile” may be much lower.

#### OTHER AUDIT DISCREPANCIES

Other discrepancies in the new IRS audit and enforcement data...

► **Regular (c) corporations** also had lower audit rates than other proprietorships, except at the largest levels. The audit rate for regular corporations rose from 0.8% for firms with balance sheet assets below \$250,000 to 1.7% for firms with assets from \$1 million to below \$5 million, and to 3% for firms with assets from \$5 million to below \$10 million.

Only corporations with \$10 million or more of assets were audited at rates higher than proprietorships, averaging 16.8%.

► **Estate tax and gift tax returns.** IRS figures show that, audit-wise, it is much safer to transfer assets to heirs by gift than by bequest.

IRS figures for 2006 (the latest available) show that estate tax returns-Form 706, United States Estate (and Generation Skipping Transfer) Tax Return—were audited at an overall rate of 9.7%, and estates with assets of \$5 million or more were audited at a very high rate of 23.4%.

But gift tax returns were audited at a mere 0.8%.

**Safety:** Three years after a gift tax return is filed, the statute of limitations expires to protect it from later IRS audit.

**Note:** Income tax returns (Form 1041, US Income Tax Return for Estates and Trusts) filed by estates and trusts were audited at an even lower 0.1% rate.

► **Personal tax returns.** The IRS audit rate for all individual tax returns rose to 1.03% in 2007 – and the IRS is publicizing the fact that this is the highest rate in 10 years, and that this audit rate has more than doubled since the all-time low rate of 0.49% in 2000.

**Reality:** The IRS has generated this higher number only by including mail contacts with taxpayers in its audit total as “correspondence audits.”

But most people consider a “real” audit to consist of being called to meet face to face with an IRS tax examiner.

These face to face audits took place at 2007 at a very low 0.23% rate—just barely more than the 0.2% rate of 2000.

► **Collection actions.** IRS levies, liens, and property seizures collapsed to all-time lows in 1999 and 2000, but while the number of levies and liens has largely recovered, the IRS still has not resumed seizing property from taxpayers as it once did.

Ten years ago, in 1997, levies totaled 3,659,417, liens totaled 543,613, and property seizures totaled 10,090.

But levies fell by 94% TO 219,778 in 2000...liens fell by 69% to 167,867 in 1999...and property seizures became almost nonexistent, plunging by more than 99% to only 74 in 2000.

In 2007, levies had increased back to 3,757,190 and liens to 683,659—but the IRS executed only 676 property seizures, still down more than 94% from 10 years earlier.

**Conclusion:** Today’s IRS will conduct “easy” collection actions such as levying money in a bank account or placing a lien on property to protect its interest. But it still has not significantly resumed the more difficult action of actually seizing property.

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I make a fortune from criticizing the policy of the government, then hand it over to the government in taxes to keep it going.

George Bernard Shaw

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**The most efficient way to obtain a tax-related criminal conviction,** the IRS has figured out, is to charge a violation of nonpayment of payroll taxes or fraudulent preparation of payroll tax returns. Small-business owners are especially susceptible to being targeted for criminal prosecution, as in businesses often employ workers who are paid off the books, in cash, and other workers who are arbitrarily treated as independent contractors. Restaurants and contractors employ millions of workers for whom payroll taxes are not paid. Latest development: Large employers are being hit. Example: Blackwater Worldwide, which provides security personnel to the U. S. government in Iraq, is being targeted by Congress for allegedly more than \$50 million of payroll taxes. I expect the IRS will not be too far behind.

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**Examination of offshore bank accounts gets IRS attention...**The IRS has reported that it is investigating more than 100 taxpayers who may be hiding assets in accounts in Liechtenstein. The Liechtenstein Global Trust Bank is the institution that apparently was complicit in money laundering activities of the targeted taxpayers. How the scheme may have worked: Instead of getting paid for the services or the sale of property, the account holders arranged to have money deposited into an off-shore account. The bank issued a credit/debit card permitting account holders to withdraw cash or make purchases. The investment income earned from the assets was not reported on tax returns.

**When the IRS rejects your offer in compromise...**The IRS will generally reject an offer in compromise if it determines that it could collect more money, albeit more slowly over time. You can file a petition with the Tax Court if you think IRS has abused its discretion in reaching its decision to reject your offer. Abuse of discretions exists if the IRS employee handling your case fails to consider information submitted to him/her or fails to follow established IRS procedures in reaching his decision.

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**Beware of relying on a family limited partnership (FLP) to reduce estate taxes...**The IRS continues to win cases in the Tax Court (Estate of Rector, TC Memo 2007-367 and Estate of Gore, TC Memo 2007-169) when an estate claims a discount of the value of securities and real estate held by an FLP. How it works: Assets are transferred, before a parent’s death, to an FLP and the parent owns the bulk of the partnership. The balance of the partnership interests are gifted to family members. When the parent dies, the estate takes a lock-of-market-availability discount so that the partnership interest owned by the decedent’s estate is worth less than the underlying property held by the partnership. FLP don’ts: Don’t create such an FLP when the decedent is elderly and infirm and the establishment of the FLP serves no business purpose other than to reduce estate tax...the decedent shouldn’t treat the assets of the partnerships as his/her own personal

account...don’t fail to legally transfer the title of assets to the FLP ( this seems obvious, but many people fail to do so)... and don’t forget to follow appropriate investment and business practices wit the FLP (changing investment strategy as needed and keeping meticulous books and other records).

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**Didn’t meet the burden of proving unreported income.** A lawyer reported receiving \$138,783 of income over two years on which he owed back taxes. The IRS examined his bank records, found \$273,409 of deposits, said \$237,541 of them were income, and increased his tax bill. Court: The IRS has the burden of proving unreported income. But here, it did not show how it decided which deposits were and were not taxable income, or how it had reduced taxable deposits by previously reported income, and “ignored actual facts of which it was aware that affect the essential accuracy of each of those amounts of alleged total unreported income.” So, it hadn’t met its burden and the increase to income is dismissed.

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**BYE-BYE!  
SEE YOU NEXT MONTH.**

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**APPLICATION FOR MEMBERSHIP IN  
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P.O. Box 725  
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asalaverne@hughes.net  
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 \_\_\_\_\_

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LaVerne Long /EXECUTIVE SECRETARY

EXECUTIVE OFFICES:

5725 HWY 18 E. • P.O. BOX 725

NEWPORT, AR 72112

PHONE 870-523-5329 • FAX 870-217-0154

[www.arspa.org](http://www.arspa.org)

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