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## NEW IRS AUDIT RULES FOR PARTNERSHIPS AND LLCs

Since 1982, the rules for IRS audits of partnerships (and LLCs treated as partnerships) generally divide partnerships in two categories as follows: (1) "Small" partnerships (generally, ten or fewer partners who are individuals, C corporations, or estates) and (2) "Large" partnerships (all others). IRS examinations and partner tax assessments for "large" partnerships are handled in a single, unified partnership-level proceeding. Any change resulting from the partnership audit results in changes to the partners' tax returns and the partners pay the tax. IRS examinations of "small" partnerships require examination proceedings directly for each partner unless the partnership elected to be treated as a "large" partnership.

Effective for tax years beginning after 2017, IRS audit adjustments to partnership items generally will be made at the partnership level. Also, additional tax (using the highest income tax rate), interest, and penalties resulting from the audit adjustments will be collected directly from the partnership. However, the following are exceptions to these new rules:

1. A partnership with 100 or fewer partners (each of which must be either an individual, estate, C corporation, or S corporation) can annually elect out of the new audit rules on a timely filed partnership return. But, if at least one partner is itself a partnership or a trust, this election cannot be made.
2. A partnership can reduce its assessed payment if either (1) partners file timely amended returns to pay the tax or (2) the partnership can show that the partners would pay a lower tax if the assessment was applied at the partner level.
3. A partnership can elect to have its partners report the audit adjustments and pay the tax on their tax returns.

Partnerships and LLCs should consider how they might want to proceed in the case of an IRS examination (e.g., which partner or other person will represent the entity in an IRS audit), and consider amending the member agreement accordingly. We will be happy to discuss how these changes might affect you.

## EMPLOYEE OR INDEPENDENT CONTRACTOR - ARE YOU AT RISK?

The highly subjective area of classifying workers continues, as it has for many years, to receive significant attention from the IRS. The federal government believes that billions in tax revenues are lost because employees are

incorrectly classified as independent contractors. The government reached this conclusion on the assumption that the misclassification gives a significant number of these workers an opportunity to underreport their income.

*(Continued on reverse)*

Employers who erroneously classify employees as independent contractors might find themselves liable for both employer's and employee's Social Security taxes, federal and state unemployment taxes, and retroactive fringe benefits for three nonprescribed years. Additionally, employers are also potentially liable for the income tax that should have been withheld.

If you own or manage a business that uses the services of independent contractors, it is extremely important that you understand the proper classification of these workers for employment tax purposes.

In 1987, the Internal Revenue Service issued Revenue Ruling 87-41, which provides a summary of the factors (the "twenty factor" test) that the IRS believes are significant in resolving employment status issues. Under pressure from Congress and from representatives of labor and business, the Service has attempted to simplify and refine the tests, consolidating the twenty factors into eleven main tests, which are organized into three main groups: behavioral control, financial control, and the type of relationship of the parties. While these tests do not rise to the level of statute or regulation, they nonetheless indicate the IRS's position on classifying workers for employment tax purposes. A summary of the Service's position follows.

### **Behavioral control**

Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of—

- ◆ *Instructions the business gives the worker.* An employee is generally subject to the business's instructions about when, where, and how to work.
- ◆ *Training the business gives the worker.* An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

### **Financial control**

Facts that show whether the business has a right to control the business aspects of the worker's job include:

- ◆ *The extent to which the worker has unreimbursed business expenses.*
- ◆ *The extent of the worker's investment.*
- ◆ *The extent to which the worker makes services available to the relevant market.*
- ◆ *How the business pays the worker.*
- ◆ *The extent to which the worker can realize a profit or loss.*

### **Type of relationship**

Facts that show the parties' type of relationship include:

- ◆ *Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.*
- ◆ *The permanency of the relationship.*
- ◆ *The extent to which services performed by the worker are a key aspect of the regular business of the company.*
- ◆ *Written contracts describing the relationship the parties intended to create.*

The Internal Revenue Service usually attempts to classify "close cases" as employees. In general, the Service tends to classify a person who is told what to do and how to do it, who is provided supplies, tools and equipment, and who works regularly for the same recipient at the same location and who can be terminated at any time as an employee. A worker who can be told what to do but not how to do it, who is not supplied with a regular workplace, who furnishes tools or equipment, and who works for others is usually an independent contractor in IRS determinations. Employee status is not affected by the amount of time a person works. For example, a person working only a few hours per week meeting the above criteria for employee status is an employee.

We will be happy to answer your questions.

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## Tax & Business Alert

AUGUST 2017

### SHOULD YOU CONVERT FROM A C CORPORATION TO AN S CORPORATION?

Many private business owners elect to incorporate, turning their companies into C corporations. But, at some point, you may consider converting to an S corporation. This isn't necessarily a bad idea, but it's important to know the ramifications involved.

#### SIMILARITIES AND DIFFERENCES

S and C corporations use many of the same record-keeping practices. Both types of entities maintain books, records and bank accounts separate from those of their owners. They also follow state rules regarding annual directors meetings, fees and administrative filings. And both must pay and withhold payroll taxes for working owners who are active in the business.



There are, however, a few important distinctions. First, S corporations don't incur corporate-level tax, so they don't report federal (and possibly state) income tax expenses on their income statements. Also, S corporations generally don't report prepaid income taxes, income taxes payable, or deferred income tax assets and liabilities on their balance sheets.

As an S corporation owner, you'd pay tax at the personal level on your share of the corporation's income and gains. The combined personal tax obligations of S corporation owners can be significant at higher income levels.

#### DIVIDENDS VS. DISTRIBUTIONS

Other financial reporting differences between a C corporation and S corporation are more subtle. For instance, when C corporations pay dividends, they're taxed twice: They pay tax at the corporate level when the company files its annual tax return, and the individual owners pay again when dividends and liquidation proceeds are taxed at the personal level.

When S corporations pay distributions — the name for dividends paid by S corporations — the payout generally isn't subject to personal-level tax as long as the shares have positive tax "basis." (S corporation basis is typically a function of capital contributions, earnings and distributions.)

#### RISK OF TAX AUDITS

C corporations may be tempted to pay owners deductible above-market salaries to get cash out of the business and avoid the double taxation that comes with dividends. Conversely, S corporation owners may try to maximize tax-free distributions and pay owners below-market salaries to minimize payroll taxes.

The IRS is on the lookout for both scenarios. Corporations that compensate owners too much or too little may find themselves under audit. Regardless of entity type, an

## WHICH COMPANIES CAN ELECT S STATUS?

Not every private business is eligible to be an S corporation. In order to elect S status, a company must:

- Be a domestic corporation,
- Have only allowable shareholders (individuals, certain trusts and estates, but not partnerships, corporations or nonresident alien shareholders),
- Have no more than 100 shareholders,
- Have only one class of stock, and
- Not be an ineligible corporation, including certain financial institutions, insurance companies, and domestic international sales corporations.

All shareholders must consent to the S election by signing Form 2553, "Election by a Small Business Corporation."

owner's compensation should always be commensurate with his or her skills, experience and business involvement.

### THE RIGHT DECISION

For businesses that qualify (see sidebar), an S corporation conversion may be a wise move. But, as noted,

there are rules and risks to consider. Also, as of this writing, there are tax reform proposals under consideration in Washington that could affect the impact of a conversion. Our firm can help you make the right decision. ■

## COOL DOWN WITH A DIP INTO YOUR TAX RECORDS

In many parts of the country, the dog days of summer are a good time to stay inside. If you're looking for a practical activity while you beat the heat, consider organizing your tax records. Granted, it may not be as exhilarating as jumping off the high dive, but a dip into these important documents now may save you a multitude of headaches later.

### TAX LAW RULES

Generally, you should keep tax-related records as long as the IRS has the ability to audit your return or assess additional taxes — in other words, until the statute of limitations expires. That means three years after you file your return or, if later, three years after the tax return's original due date.

In some cases, the statute of limitations extends beyond three years. If you understate your adjusted gross income by more than 25%, for example, the period jumps to six years. And there's no statute of limitations if you fail to file a tax return or file a fraudulent one.

### LONGER PERIODS

Although the IRS statute of limitations is a good rule of thumb, there are exceptions to consider. For example, it's wise to keep your tax returns themselves



indefinitely because you never know when you'll need a copy of your individual income tax return.

For one thing, the IRS often destroys original returns after four or five years. So if the IRS comes back 10 years later and claims you never filed a return for a particular year, it can assess tax for that year even though the limitations period for properly filed returns has long since expired. As you can see, it would be difficult to defend yourself without a copy of your tax return.

W-2 forms also are important to keep at least until you start receiving Social Security benefits. You may need them if there's a question about your work record or earnings in a particular year.

## PROPERTY AND INVESTMENTS

If you have property records, it's ideal to keep closing documents and records related to initial purchases and capital improvements until at least three years (preferably six years in case you understated your income by more than 25%) after you file your return for the year in which you sell the property.

When it comes to sales of stocks or other securities, retain purchase statements and trade confirmations until at least three years (preferably six years) after

you file your return for the year in which you sell these stocks or other securities.

## GRAINS OF SAND

Many years' worth of tax and financial records can accumulate like grains of sand on your favorite beach. So the better your documentation is organized, the easier time you'll have filing your return every year and dealing with any IRS surprises. Our firm can assist you in determining what you should keep. ■

## IRS PERMITS HIGH-EARNER ROTH IRA ROLLOVER OPPORTUNITY

Are you a highly compensated employee (HCE) approaching retirement? If so, and you have a 401(k), you should consider a potentially useful tax-efficient IRA rollover technique. The IRS has specific rules about how participants such as you can allocate accumulated 401(k) plan assets based on pretax and after-tax employee contributions between standard IRAs and Roth IRAs.

### HIGH-EARNER DILEMMA

In 2017, the top pretax contribution that participants can make to a 401(k) is \$18,000 (\$24,000 for those 50 and older). Plans that permit after-tax contributions (several do) allow participants to contribute a total of \$54,000 (\$36,000 above the \$18,000 pretax contribution limit). While some highly compensated supersavers may have significant accumulations of after-tax contributions in their 401(k) accounts, the tax law income caps block the highest paid HCEs from opening a Roth IRA.

However, under IRS rules, these participants can roll dollars representing their after-tax 401(k) contributions directly into a new Roth IRA when they retire or no longer work for the companies. Thus, they'll ultimately be able to withdraw the dollars representing the original after-tax contributions — and subsequent earnings on those dollars — tax-free.

### AN EXAMPLE

Participants can contribute rollover dollars to conventional and Roth IRAs on a pro-rata basis. For example, suppose a retiring participant had \$1 million in his 401(k) plan account, \$600,000 of which represents contributions. Suppose further that 70% of that \$600,000 represents pretax contributions, and 30% is from after-tax contributions. IRS guidance clarifies that the participant can roll \$700,000 (70% of the



\$1 million) into a conventional IRA, and \$300,000 (30% of the \$1 million) into a Roth IRA.

The IRS rules allow the retiree to roll over not only the after-tax contributions, but the earnings on those after-tax contributions (40% of the \$300,000, or \$120,000) to the Roth IRA provided that the \$120,000 will be taxable for the year of the rollover.

Alternatively, the IRS rules allow the retiree to delay taxation on the earnings attributable to the after-tax contributions (\$120,000) until the money is distributed by contributing that amount to a conventional IRA, and the remaining \$180,000 to the Roth IRA.

Under each approach, the subsequent growth in the Roth IRA will be tax-free when withdrawn. Partial rollovers can also be made, and the same principles apply.

### GOLDEN YEARS AHEAD

HCEs face some complex decisions when it comes to retirement planning. Let our firm help you make the right moves now for your golden years ahead. ■

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## SHIFTING CAPITAL GAINS TO YOUR CHILDREN

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If you're an investor looking to save tax dollars, your kids might be able to help you out. Giving appreciated stock or other investments to your children can minimize the impact of capital gains taxes.

For this strategy to work best, however, your child must not be subject to the "kiddie tax." This tax applies your marginal rate to unearned income in excess of a specified threshold (\$2,100 in 2017) received by your child who at the end of the tax year was either:



1) under 18, 2) 18 (but not older) and whose earned income didn't exceed one-half of his or her own support for the year (excluding scholarships if a full-time student), or 3) a full-time student age 19 to 23 who had earned income that didn't exceed half of his or her own support (excluding scholarships).

Here's how it works: Say Bill, who's in the top tax bracket, wants to help his daughter, Molly, buy a new car. Molly is 22 years old, just out of college, and currently looking for a job — and, for purposes of the example, won't be considered a dependent for 2017.

Even if she finds a job soon, she'll likely be in the 10% or 15% tax bracket this year. To finance the car, Bill plans to sell \$20,000 of stock that he originally purchased for \$2,000. If he sells the stock, he'll have to pay \$3,600 in capital gains tax (20% of \$18,000), plus the 3.8% net investment income tax, leaving \$15,716 for Molly. But if Bill gives the stock to Molly, she can sell it tax-free and use the entire \$20,000 to buy a car. (The capital gains rate for the two lowest tax brackets is generally 0%.) ■