

S Corporation and Salaries to Owners: *Beware of the Pitfalls*

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A common planning area for S Corporations is the salaries paid to owner/employees. By paying a low salary and taking other funds from the corporation as "distributions of earnings" you avoid social security and Medicare tax on the distributions.

This is because "salaries and wages" are taxable as compensation and thus have a total of 15.3% social security and Medicare tax, including the employee and employer's share. Distributions of earnings are not compensation and thus do not have any employment taxes related to them. So what's wrong with doing just that and saving 15.3% in taxes?

There is the old saying that if it looks too good to be true, it probably isn't true. This

is in part the case we have here. In order for this tax planning opportunity to work, the salaries and wages paid to owner/employees have to be reasonable compensation considering the employees expertise and experience. So if you, as the owner/employee, are taking \$24,000 per year in salary and another \$20,000 as distributions, but you are "worth" \$50,000 in salary, this will not stand the scrutiny of an IRS audit. You first have to pay a reasonable compensation to employees before you can take S distributions.

The IRS has also attacked a long-held belief that if you spend little time there and have a manager run the show, you don't need to take

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Changes to the Home Sale Exclusion

Recent law changes through, "The Housing Assistance Tax Act of 2008" represent a tax planning complication for those who own multiple dwellings and hope to maximize their use of the home-sale exclusion with respect to more than one of the homes. The exclusion amounts are; up to \$500,000 for married filing joint filers and up to \$250,000 for all other filing types.

In the past, taxpayers could purchase an investment property, use it for something other than a principal residence, and then make the property their principal residence for two years before selling in order to take full advantage of their gain exclusion on the property. Now, part of that gain may be ineligible for the exclusion.

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S Corp Salary Issues (continued)

compensation but can take all income as distributions. In this case, the IRS argued that the owner needed to take a salary to compensate himself for his CEO duties. In this case, he spent little time at the store, but he oversaw the operations, hired managers, prepared budgets and set store prices and as such, needed to take a salary.

The IRS has been rattling their saber for some time now, and we expect to see them pursuing this issue in the future. If you have an S Corporation, planning in this area is essential to avoid payroll taxes. Don't think the issue will go away, especially considering the financial shape of the social security system, the baby boomers are coming and will stress the system to its

limits!

Something else in this area to consider is that if you limit your compensation, you will have FEWER benefits when you reach retirement age for social security purposes. Another potential snare is that retirement plans are primarily based on salaries to determine company contributions. Thus, by paying a lower salary, it lowers the amount contributed to the owner's retirement account.

If you have questions on this or any other tax issues, please do not hesitate to contact our office.



Energy Efficiency Credits Make a Comeback

The residential energy efficient credit available in 2006 and 2007 has made a comeback for 2009 and 2010. The comeback includes an increased credit of 30% of the cost of residential energy-efficient improvements such as more efficient furnaces, heat pumps and air conditioners, as well as energy-tight windows and insulation. The maximum credit for a household has been tripled to \$1,500. Here are the details:

- ◆ Credit only applies to principal residence
- ◆ the 10% credit rate is increased to 30%
- ◆ the dollar limitations on residential energy property expenditures have been eliminated; instead, all energy property that was previously eligible for the \$50, \$150, and \$300 credits is now eligible for a 30% credit
- ◆ the \$500 lifetime cap (\$200 for windows) is eliminated and replaced with an aggregate \$1,500 cap for 2009 and 2010

To document that the improvements qualify for the credit, the taxpayer needs to check with the manufacturer of the product. The manufacturer will be able to provide you with certification that the product qualifies for the credit, which should be retained in case of audit. If the manufacturer cannot provide you with certification, the product most likely does not qualify for the credit.

If you have questions on this or any other tax issues, please do not hesitate to contact our office.



QuickBooks Corner — Common Year-end Problem Areas

Do you ever wonder how your accountant determines if there are errors in your QuickBooks data? Many small business owners focus solely on the profit and loss statement. However, it is very important that you understand where all of the numbers come from on your balance sheet. By looking at your balance sheet accounts, you can tell if there are obvious errors that will ultimately impact the accuracy of your profit and loss statement. For instance, if you have a negative accounts receivable balance, you know you will need to do some research to find out why. Here are some other balance sheet and data items to look for that may indicate a problem:

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Home Sale Exclusion Changes (continued)

For property sales that occur after 2008, the gain that is allocable to periods of "nonqualified use" prior to the property's use as the taxpayer's primary residence is not excluded from the taxpayer's income. A period of nonqualified use is any period after 2008 in which the property is not used as a principal residence by the taxpayer, the taxpayer's spouse, or former spouse. Other restrictions regarding eligibility for the exclusion apply if a taxpayer acquires property in a tax-free like-kind exchange, or if the property had been put to a use for which depreciation was allowable such as a rental.

For example, a married taxpayer purchases a mountain vacation home January 2004. Ten years later, Then in, January 2014, the taxpayer converts the vacation home to their principal residence and uses the property as their residence for five years. January 2019 the taxpayer sells the property at a gain of \$500,000. Under the old rules, the entire \$500,000 could be excluded from tax. With the law changes, only \$333,334, could be exempt from tax with \$166,666 taxable as a

capital gain. Nonqualified use (2009 through 2013 five years vacation home use) divided by total ownership period (15 years) gives us the allocation between excludable gain of 2/3, and taxable gain of 1/3.



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Personal service. Professional results.

Mission Statement

Our mission is to provide quality personal service, with professionalism; integrity and a commitment to assisting our clients achieve their goals.

Guiding Principles


To foster a close personal relationship with our clients, focusing on the long-term.

To earn the respect and trust of our clients.

To provide competent, timely service to all of our clients.

To use our abilities and contribute back to the communities in which we live.

To enjoy what we do. (Really accountants can!)



We're on the web!
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QuickBooks Corner— year end problems (continued)

- ◆ Negative inventory
- ◆ Negative accounts payable
- ◆ Inaccurate loan and liability balances (especially payroll liabilities)
- ◆ Duplicates in chart of accounts
- ◆ An account called "Opening Balance Equity" (simply a plug figure generated by QuickBooks)
- ◆ Duplicates in vendor and customer lists

Reviewing the balance sheet and correcting errors will allow year-end review and tax return preparation to be more efficient, make your financial data more accurate, and allow you to manage your business better.

If you have questions or need help with QuickBooks, please call our Buckner Wadsworth & Associates, LLP QuickBooks advisors.