

WINTER 2005

Quill

NEWSLETTER

During this Holiday Season, we
THANK YOU

for letting us work with you! Our best wishes to you for a Healthy and Prosperous New Year.



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Year-end Tax Planning: a Misnomer or a Procrastinator's Last Option?

Jack Sullivan, Partner

In an annual ritual, sometime between the departure of the leaf peepers and the arrival of Thanksgiving, accountants, tax attorneys, financial planners, investment advisors, and various publications bombard the electronic and written media with a plethora of articles about year-end tax planning. To the average taxpayer, this is a once a year process accomplished in the last calendar quarter. However, effective tax planning should be an ongoing effort throughout the year, especially if you are also a business owner. As we determine our tax strategies for the current year, we should also be doing so for the coming year, and when feasible, for the years beyond. Not only should we be focused on the annual income tax we expect to pay, but also on the legacies we expect to leave behind and the consequences of our estate taxes. Planning strategies for these two taxes are not always compatible, and one must be careful to navigate the best possible course between them.

Although most of us accept the necessity of income taxes and feel morally responsible for paying them, we are nonetheless human and hate to depart with a dollar before we have to or incur more than our fair share. Herein lies the essential benefit of tax planning; the postponement of taxes whenever legally possible, and paying of the lowest possible tax given the current regulations. The latter presents a significant challenge, as Congress repeatedly sees fit to change the playing field by revising the rules (often retroactively) and in many cases to discourage behavior they had encouraged in the past. For example: spending vs. savings; rewarding tax shelter investments, then not. Similarly, our state legislators of late have found it increasingly difficult to keep up with and pay for the federal tax incentives, and more frequently decide to decouple themselves from the federal laws, further complicating the process.

Tax deferral is a common goal, but cannot be undertaken in a vacuum. To do so without thought to the future can backfire, if income is postponed to a later period in which an individual or a business is in a higher tax bracket. If there is a significant spread between tax brackets in adjoining years, the strategy is normally to plan so that the lowest overall tax is incurred between the years. Thus sometimes the strategy is reversed, with income being accelerated and expenses deferred. Between the currently lower tax rates, and the attention being given to increasing federal deficits, there is talk of bridging the budget gap through tax increases. Could it be that we are now enjoying the lowest tax rates that we will see for a while?

It goes without saying that having up to date and accurate financial records is an integral part of the planning process. Over the past several years, technology, including the advent of user-friendly software, has facilitated this objective, and most small businesses (even those with no professional accounting or bookkeeping staff) can now produce timely and reasonably accurate financial records.

One of the best ways to defer taxes is to pay yourself in the form of disbursements that are currently deductible to the business, but not taxable to you. Often heralded but frequently underutilized, retirement plans are a win-win and therefore, a must must. Many businesses have found that it is much easier to recruit and retain employees when some type of retirement plan is offered, even if it is self-contributory with minimal employer contribution.



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With this in mind, there is even a plan that can be implemented after year end and applied to the prior year (the SEP-IRA), but for many it may not be the right plan and may prove prohibitively expensive to implement. Many small businesses change the type of plan they utilize as their businesses evolve. Either the income available to the owner changes, the owner ages, the number and compensation of employees changes, family members are added to the payroll, or disposable cash varies.

While some plans can be set up at the last moment and funding delayed until the due date of that year's tax return (including extensions), the best plan for you and/or your business may be a 401(k) or a SIMPLE plan, which requires that there be prospective earnings and employee notifications before they can be implemented. Therefore, it's best to look forward and not wait until the last quarter of the year. For a significant number of businesses in Maine, the best fit may be such a voluntary deferral plan. Thus, waiting until the end of the year may be too late to shelter any current year income.

Tax planning is a lot like holiday shopping. You can wait until the last minute, but the choices may not be what you envisioned, and you may be forced to take what is left and at a price you did not plan on paying. Therefore, as you put the finishing touches on 2005, look to 2006 and beyond. Also, take the time to look over other bridges you and your business will have to cross in the future: business succession, insurance coverage, your will, estate plan, etc. to ensure your current strategy is in harmony with your long term goals.

Employee vs. Independent Contractor: What Is the Difference?

Amy Rossignol, Supervisor

Classifying an individual as an employee or independent contractor has been a much publicized topic of conversation in recent years. The primary reason is that the misclassification of employees as independent contractors results in federal and state governments losing millions of uncollected tax dollars each year.

In addition, individual workers are losing out on unemployment benefits and appropriate levels of worker's compensation insurance.

What is the difference between an employee and an independent contractor?







An employee is anyone who performs services for someone whereby the person for whom the services are being performed can control what and how the work will be done.





On the other hand, a service performer who has control over what and how the work will be done is known as an independent contractor. Independent contractors are not subject to payroll taxes. However,

employers must send independent contractors a Form 1099-MISC if they are paid in excess of \$600 in any given year.

In order to determine whether an individual is an employee or an independent contractor, the IRS examines the degree of control and independence the individual has in relation to the business.

The following is a list of questions to ask in order to distinguish between an employee and independent contractor:

-  How much control does the employer have to direct the work being done?
-  Does the employer provide the individual with training and instruction?
-  How much unreimbursed business expense will the individual have?
-  How does the employer pay for the individual's services?
-  To what extent does the individual make their services available to the public?
-  Is there a written contract describing the relationship between the individual and the employer?

-  Is the individual able to perform the services for other businesses?
-  What is the duration of the relationship?
-  Is the individual provided with employee benefits from the employer?
-  To what extent are the services performed by the individual part of the employer's regular course of business?

Typically, if an individual incurs significant unreimbursed expenses, devotes a significant amount of time to the services being performed, is paid a flat fee amount, can make a profit or loss on the services performed, and is not provided employee benefits by the employer, the individual will most likely be classified as independent contractor.

Be aware that if a worker is classified and paid as an independent contractor, but later determined to be an employee, employers can be held liable for any of that worker's unpaid employment taxes, plus interest and penalties. For more information on this evolving topic, visit the IRS website at www.irs.gov and research *Publication 15-A*.



MAINE TAX TIDBITS

Solar Rebate Program:

On June 29, 2005, Governor Baldacci signed into law legislation creating a solar rebate program for qualified solar energy systems. The law, which became effective September 17, 2005, provides for the following rebates on systems installed in homes or businesses after July 1, 2005:

- * Solar thermal systems designed to heat water or air - Rebates of up to 25% of the cost of the system up to a maximum of \$1,250.
- * Solar photovoltaic (PV) systems (solar electric systems) - Rebates of \$3 per watt for the first 2,000 watts of installed capacity and \$1 per watt for the next 1,000 watts (\$7,000 maximum rebate).

Individuals interested in taking advantage of the program should proceed cautiously, as the Maine Public Utilities Commission is currently in the process of adopting rules necessary to implement it. Also, the law (L.D. 1586) requires that the installers of the system meet certain requirements.

Further information can be found on the Commission's State Energy Program website at <http://www.maine.gov/msep/>.

INTERNAL REVENUE SERVICE TIDBITS

In addition to the recent emphasis in the area of vehicle donations, the Internal Revenue Service (IRS) has numerous other areas under scrutiny including the following:

Individual Compliance Examinations:

The IRS recently completed analyzing the results of approximately 46,000 compliance audits of individuals randomly selected among various income groups, they concluded that there is a difference of \$325 billion dollars between what taxpayers should pay and what they do pay. The IRS estimates that only about \$50 billion of this amount is being recovered via IRS audits and other enforcement activities. The main culprits:

Self Employed Individuals

Understating income and overstating deductions.

Partnerships and S-Corporations

Failure to report business income on the personal returns.

Tipped Employees and Gamblers

Understating gratuities and winnings.

As a result of these findings, the IRS is revising its return selection formulas to increase the likelihood of auditing returns with underreported tax obligations, and is increasing the number of planned examinations, with an emphasis on the upper-income and self-employed taxpayers.

The IRS is also expected to expand its Form K-1 document matching program; comparing the income and deductions reported by partnerships, S-Corporations and trusts on Form K-1 with the amount reported by the individual partner, owner or beneficiary.

IRS Focus on S-Corporations:

The IRS has announced that during the later part of 2005 it will begin con-

ducting special audits of about 5,000 S-Corporation returns as part of its program to improve taxpayer compliance, and to revise its own return selection formulas (to increase the likelihood of auditing returns with underreported tax obligations). The returns are expected to be selected randomly among S-Corporations of various sizes.

The audits will be conducted on returns filed for the 2003 and 2004 tax years, and are expected to focus not only on whether the S-Corporation has properly reported income, deductions and credits, but also whether the owners have properly reported these items on their individual returns as they are "passed-through" from the Corporation.

At the Corporate level, we would expect the IRS audits to be quite comprehensive and include matters such as owners' compensation and related party activities, in addition to the determination of whether revenues are being properly reported and that deductions are for legitimate business purposes.

In light of the increased scrutiny, it is becoming ever more important to maintain good financial records and practices. Companies should have established revenue recognition policies and procedures, have a system in place to ensure expenses are supported by proper documentation, and have personal disbursements, nondeductible expenses (such as meals and entertainment) and similar items identified and properly reflected in the accounting records. Furthermore, the business purpose of transactions with affiliated companies or individuals should be clearly documented.





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NEW FACES



Anne Jameson started with RKO on July 5th as an in-charge accountant. Anne received her MBA from Thomas College and has three years experience with the State Department of Audit; she was responsible for auditing the DHS program for the State. She also worked several years with the Maine Revenue Service as a revenue agent and tax examiner.



Patrick Sage joined RKO as a staff accountant August 8th. He graduated from Western Michigan University and moved to Maine this past January.



Beth Mullin joined the senior ranks of RKO effective November 28th. Beth graduated with a Master of Science in Accounting degree from Northeastern University. For the past five years she has worked in Boston in the governmental department of a national accounting firm and will continue similar work here in RKO's municipal practice. Beth makes her home in Saco.

Member of:

