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PARTNERS BEYOND BOUNDARIES

Business owners - beware of IRS red flags

Blackbeard, Christopher Moody, Edward Low, and Henry Every… just a few of the more infamous pirates to have hoisted a fear-inspiring red pirate flag at one time or another to intimidate their prey. The dreaded red flag, a symbol that came to be known throughout maritime history to mean no quarter would be given, no mercy, no life would be spared from the pirate ship flying it. Just as a red flag came to be instantly recognizable by seamen who scanned the horizon hoping to never come across a pirate ship bearing one, business owners should be scouring their balance sheet, income statements, and financial statements for their own red flags. Below are red flags business owners should be on the lookout for.

One red flag the IRS will be sure to search for upon audit on the balance sheet are loans from the business to the owners. Very often a shareholder receivable is not actually a loan from the business to the owners at all, but instead a reclassification that was made to avoid a taxable distribution when an owner lacks basis to take a distribution. The IRS will search for interest on that loan, in many cases will find none, and decide to impute it. To be considered a bona fide loan, the IRS wants to find a written agreement signed by both parties with a reasonable interest rate, payment terms, and see that payments during the year have been made. The last thing you want is the IRS deeming no bona fide loan was made as they could recharacterize those monies as a taxable distribution subject to capital gains tax, or worse, wages subject to the regular tax rate at the personal level in addition to payroll taxes.

A more common red flag often found on the balance sheet are loans from the owners to the business. If stock basis is fully depleted, loans provide debt basis in which losses can then be deducted. Losses in excess of stock and debt basis are non-deductible and suspended until basis is restored. Basis should be tracked since inception of a company as it can be difficult to recreate years down the road and can be costly to the client. If the business has been experiencing losses the IRS will be curious to see if the owners have been taking losses in excess of basis on their personal tax returns. The IRS will also search for interest on the loans, in many cases will find none, and may decide to impute it. Once again the IRS wants to find a written agreement signed by both parties with a reasonable interest rate, payment terms, and see that payments during the year have been made. Also, a hidden pitfall can happen when the debt basis has been completely used up and the loans are repaid before the basis is restored, resulting in a taxable gain.

Sometimes these are not actually loans at all as the owners have no intention of the business ever paying them back, in which case the amounts should be reclassified to equity as a capital injection. Regarding S Corporations, the IRS may view this as a second class of stock. Without proper documentation, the IRS could terminate the S Corporation status.

Problems may arise when C Corporations convert to an S Corporation and have undistributed Accumulated Earnings and Profits *('AE&P')* on the day the S election is granted. The AE&P will carry over to the S Corporation and will become taxable at some point, such as when an S election terminates, AAA has been reduced to zero and distributions are made, or when the company is sold. It may be wise to elect to take distributions out of AE&P first if a company is having a down year to whittle away the AE&P *(which will be subject to capital gains rates)*. Problems may also arise if a company has excess net passive income *(rents, royalties, interest, or dividends)* and AE&P. Though

rare, an S election can be terminated if during a three year period a company has both AE&P as well as passive income over 25% of gross receipts in each of those years.

Some areas that stand out easily are negative balances both on the balance sheet and income statements. If one is spotted a question should be asked why. Very often these negative balances are due to posting errors and should be corrected. Sometimes negative liabilities can actually be an overpayment or a refund due. Negative equity can mean more money has been taken out of the business than has been made over the years. Occasionally you will see a clearing account that has been created by QuickBooks, which means that expenses are understated or overstated. Also, look for balance sheet accounts that have not changed in the past few years. Is this balance correct, or should it be written off?

A second look should be taken at accounts called 'Other' or 'Miscellaneous'. It is commonplace to see these accounts with immaterial balances. However, there are times when one of these accounts has a sizeable balance. When that happens take the time to find out what the balance really is and reclassify it. These are accounts the IRS typically request general ledger detail to see what are in them.

Another red flag may be when accounts receivable and inventory have been rising in relation to sales. Having too much inventory on hand could mean there is not enough demand for a product, or that too much inventory has been made or purchased too soon and just cost you extra money by remaining unsold. If accounts receivable are rising does that mean that more are becoming uncollectible? Until the accounts receivable are collected this will impact cash flow used for other necessary operating expenses.

One should take a look to see if there is a history of declining revenues the past few years. The first things most companies do when revenues decline is try to cut unnecessary costs, as well as reduce payroll *(either through staff reductions or benefit reductions).* If it is found that the profit margin has not been impacted positively by the cost cutting measures undertaken, the company most look elsewhere to move in the right direction. The next questions that should be raised are whether the selling price should be increased, if the quality of the product should be increased, is not enough advertising being done, is it a function of location, or a combination of the above.
The balance sheet can also be examined to see if liabilities have been growing disproportionately over an increase in assets. This may be a sign the company is over-leveraged. With some businesses this is seasonal *(such as construction companies typically being slower during winter)*, but should be watched more closely if becoming year-round. A quick check a company can do is to look at their debt to equity ratio. If this is over 100% there is cause for concern. Another red flag should be raised if a company finds its falling interest coverage ratio to be less than five *(found by dividing your net interest payments by the operating earnings)*.

Time should be taken now to scan for potential red flags, as early detection can result in a business righting their ship, and steering the right course away from trouble. Please feel free to contact your Dermody, Burke & Brown tax advisor to further discuss any questions you may have.

Courtesy: Dermody, Burke & Brown, CPAs, LLC