

Form 1099: New 2016 IRS developments are of concern

Congress has once again decided that the easiest way to collect money is to increase penalties. If you are guilty, the only thing you can do is pay up. So it's easy to make taxpayers pay more.

This time, it is once again form 1099 that has attracted Congress' interest. Just a few years ago, the penalty for failing to file a 1099 form was \$10. No big deal. Then the IRS increased the amount to \$30. Now it's \$50 per 1099 if filed within 30 days after the due date, and \$250 for failure to file. Don't even think about knowingly not filing. So now it is a big deal.

These forms must be filed by businesses who pay for the services of individuals who are not employees, such as part timers, commission-only salespeople, and individuals hired for a specific job such as day labor, a repair project or computer services. The individuals must earn more than \$600 during the calendar year. Forms need not be filed if the services are performed by a corporation.

There is one exception — lawyers must be given a 1099 for any amount paid for their services and even if incorporated.

The tax court has a case of interest to those who have multiple corporations. Reps sometimes have two corporations, one for commission basis and one for distribution of stocked merchandise. In this case, the owner had two different businesses, one successful and the other basically a start-up organization developing a new product in a different market area. To develop this product, a computer technician was employed by the start-up company with the understanding that he would also work for the successful company. On this basis, the successful company paid large fees to the start-up for the technician's (part-time) services.

Upon audit, the IRS did not merely disallow most of the expense, but it declared the amounts as dividends to the shareholders. Only a "reasonable" fee for services was allowed to the successful company.

This represents a danger to any multiple corporation situation. While not specified, it appears that both companies were regular corporations. The results with S corporations could yield different results. The tax position

in the case of the regular corporation would remain the same; disallowance would result in taxable income to the shareholders. However, that would give them basis in the start-up corporation to deduct the resulting loss, largely offsetting the taxable income.

The IRS may be able to successfully argue that the start-up costs should be capitalized and amortized over 15 years. Even then, the shareholders would get the deduction. Also, a consolidated corporation tax return could alleviate the problem because the shareholders would not be involved as intermediaries.

Finally, we have a case won by the IRS that again concerns compensation. In this case it was a law firm that distributed its profit in full to the attorney shareholders at the end of the year. Because this is a "service" corporation, its net profit is taxed at a flat rate of 35 percent instead of the graduated rates for regular corporations. This results in the shareholders' desire to distribute all profit to the shareholders whose combined tax rates may result in total taxes less than 35 percent.

The IRS successfully attacked the compensation as excessive based on two concepts. First, the firm had many employees who were not stockholders; they helped provide the excess of income over expenses, so the corporation should have shown a reasonable profit based on their initiative. Second, the stockholders should be rewarded with a return on investment, hence a taxable profit. The court admitted that capital doesn't rate much importance compared with accomplishment in a law firm, but said that nothing was too little.

It seems we've lost something here. The 35 percent tax was imposed because "service" firms were letting corporations accumulate income at the graduated rates rather than taking the money out as personally taxable. Congress wanted the professionals to withdraw the money and pay tax rather than have the funds accumulate.

So here we've come full circle where you're NOT supposed to take it ALL out. How much is enough? Where there are not many non-shareholder employees, the IRS argument might not stick. It seems that corporations should not be so exacting that the profit always amounts to zero.



by Stanton B. Herzog, CPA
ERA Tax, Audit & Accounting Consultant

Stanton B. Herzog, CPA, principal in the firm of Applebaum, Herzog & Associates, P.C., Northbrook, Ill., serves as ERA's accountant and is a regular contributor to The Representor. He is available to speak at chapter or group meetings on a variety of financial and tax-related topics. He also participates in Expert Access, the program that offers telephone consultations to ERA members.

You can call Stan Herzog at 847-564-1040, fax him at 847-564-1041, or email him at sherzog@theahagroup.com.