

KAKIMOTO AND CO.
CERTIFIED PUBLIC ACCOUNTANTS
1515 WEST 190TH STREET, SUITE 208
GARDENA, CALIFORNIA 90248-4328
PHONE (310) 715-9100
FAX (310) 715-9830

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PENALTIES ON LATE PAYMENT OF PAYROLL TAX DEPOSITS

It is imperative that payroll tax deposits be made on time. The employer has an obligation to withhold taxes from the employee's wages and remit the entire amount along with the employer's portion to each taxing authority by their due dates. The federal due date of either monthly, semiweekly or others, is determined based on the history of total taxes reported, referred to as the "lookback period." Under the monthly deposit rule, payroll taxes must be deposited by the 15th day of the following month. Under the semiweekly rule, taxes withheld on payments made on Wednesday, Thursday, and/or Friday must be deposited by the following Wednesday. Taxes withheld on payments made on Saturday, Sunday, Monday, and/or Tuesday must be deposited by the following Friday. Also the term 'payday' refers to the actual date that the check is made. Because the payday determines the due date, please be aware of the dates. If the deposits are made late, the following penalties will apply.

Federal

- | | | |
|-----|---|--|
| 2% | - | Deposits made 1 to 5 days late |
| 5% | - | Deposits made 6 to 15 days late |
| 10% | - | Deposits made 16 or more days late or amounts paid to the IRS within 10 days of the date of the first notice the IRS sent asking for the tax due |
| 15% | - | Amount still unpaid more than 10 days after the date of the first notice the IRS sent asking for the tax due or the day on which you receive notice and demand for immediate payment, whichever is earlier |

CA

The State of California has been inconsistent in their assessment of penalties for late payment of payroll tax deposits. In the case that penalties are assessed, a notice will be sent out by the Employment Development Department (EDD). Also, if deposits are not made at all, upon conviction, an amount not to exceed one thousand dollars, or imprisonment for not more than one year, or both the fine and imprisonment may be made at the discretion of the court.

TREATMENT OF LOANS BY THE IRS

When a stockholder receives an advance from a corporation, it is important that the tax effects also be considered. The corporation has the following three options for this treatment.

1. Treat as a loan receivable
2. Treat as a wage/bonus advance - In this case, the stockholder will report this as income and the corporation will take a deduction.
3. Treat as a dividend - The stockholder will report this as income but the corporation will not be allowed to take a deduction.

Although the shareholder's preference is to treat the advances as loans, the IRS will examine loans to and from the corporation carefully.

The intent of the shareholder is an important factor when determining the advance as a loan or dividend. In the case of treating it as a loan, the corporation must be acting as a lender and the shareholder must be treated the same as if the corporation was lending to a third party. Also, the shareholder must have the intent to repay the debt, and the corporation must fully intend to enforce its obligation. It is important that both parties be able to demonstrate the above at all times. Several factors are used by the court to determine whether the advance is a loan or a dividend. The following are some guidelines.

1. The extent to which the corporation is controlled by the shareholder.
2. The corporation's dividend payment history.
3. The dollar amount of the advance payment.
4. The terms of the advances, including security, repayment, and interest rate.
5. If there was a formal certificate issued to the borrower.
6. If there was a formal and enforceable obligation to repay.
7. If there have been repayments or attempts to collect payment.

Meeting one factor alone will not guarantee loan treatment, but it is extremely critical when taken as a whole to prove to the IRS that the intent of the advance was to be a loan.

Tax planning

Advances from a closely held corporation should be done with extreme care, especially if the corporation is controlled by a single shareholder. In order to prove that the withdrawals are loans, the following two factors become critical. (1) the repayment of the advances, and (2) formalization of the advances as debt. Regarding the first factor, both parties should document the borrower's ability to repay the advance, and establish a schedule for the repayment of the debt. As for the second factor, formalization can provide support as to the intent of the parties. Although there have been instances where the taxpayers have prevailed without the formalization of the advances as debts, we still strongly recommend that the transaction be formalized. The parties should include a reasonable interest rate, terms and security if there are any. Also, the corporate minutes can be used to support the transaction.

Unrestrained withdrawals of large dollar amounts will almost always be treated as a dividend by the IRS. Also, if the shareholder continually withdraws funds from the corporation and the shareholder loan receivable steadily increases, the IRS will most likely treat this as a constructive dividend.

The treatment of an advance needs to be carefully planned. The advances will be treated as a loan only in the case that the shareholder and the corporation treat each other as a true debtor and creditor.

PROMOTIONAL SERVICE

Kakimoto and Co. is currently offering to provide to our valued clients, and any new clients, quality services at a 30% discount of our standard hourly rates. This special offer is available through the end of November 30, 1995.

This offer applies *only* to any new projects or consultations, such as computerizing your accounting system, evaluating internal controls, preparing fixed asset ledgers, various accounting or management consultations, and other nontraditional accounting engagements. The discount does not apply to existing and ongoing engagements in which the terms have been previously agreed upon.

If you are interested or have any questions, please call Gerald Kakimoto or Carol Kakuma at (310) 715-9100.

We at Kakimoto and Co. have decided to maintain a "Q & A" section in our newsletters. If you would like us to answer any questions regarding your daily accounting, tax, finance, computers, and/or management, please feel free to submit your questions to Gerald Kakimoto or Carol Kikuma by phone, fax, or letter. We would like to discuss some of your questions in our newsletters. If you have a specific topic in mind, please do not hesitate to contact us.