



# **Operating A Business:**

## **Tax Considerations**

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# Operating A Business: Tax Considerations

Tax accounting and recordkeeping play a major role in operating your business and how much you must give to Uncle Sam. The purpose of this guide is not to make you an expert on these topics. Instead, its goal is to give you a basic understanding of business taxation so that you can maximize your profits and minimize your taxes.


## The Bird's Eye View

The IRS requires that you share some of your profits and gains with it. The rules and reporting requirements are complicated and you'll need professional help to keep in compliance.

The form and nature of your business determines what taxes you need to pay and when and how those payments must be made. The most common business taxes are:

- Income tax;
- Self-employment tax;
- Employment taxes; and
- Excise taxes.

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***The bottom line:*** Regardless of whether you chose to operate your business as a sole proprietorship, partnership, LLC, LLP, S Corp, or C Corp, the business must have a separate set of accounts. If there is more than one owner of the business, this seems obvious. It is just as necessary in sole proprietorships. If for no other reason, gains, income and losses attributable to the business must be recorded for income tax purposes.

Unfortunately, you have to share your profits and gains with the government. To determine how much you have to share, you need to become familiar with tax accounting.

## Keeping “Accounts”

The notion of keeping “accounts” is more complex than you might first imagine. Accounts help you manage your business, measure its financial strength and determine your profit. Financial accounting, management accounting and tax accounting all have different objectives.

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In sole proprietorships, the business owner has no legal distinctiveness from the business itself. For liability purposes the owner and business are identical. As a general rule, for tax accounting, the owner and the business have the same tax year. Business income, expenses and losses are reported on the owner's income tax return.

In businesses that separate the business liabilities from the owner's assets, the entity that conducts the business has separate income and liabilities. Business profits and losses will either be quarantined at the entity level or passed through to the owners, depending on the business entity's tax characteristics.

## Filing Tax Returns

All businesses must file an annual tax return, with most of the numbers for that return coming from accounts that your business maintains year-round.

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- A sole proprietorship must file Form 1040 Schedule C.
  - All other businesses file either an information return, their own income tax returns, or both.
  - Corporations file Form 1120 or 1120S and make estimated tax payments with Forms 1120-W and 8109.
  - Partnerships file Form 1065.

Generally, corporations pay tax on their income and are required to file income tax returns. Corporations are taxed on their profits when earned. These profits are taxed again when paid to the owners as dividends. Losses incurred by the corporation are quarantined at the entity level. In simple terms, the owners (shareholders) of a corporation cannot offset their income by using the company's losses.

S Corporations (S Corps) are taxed differently. An S Corp is generally exempt from federal income tax. However, it is liable for certain capital gains and income tax on passive income.

Partnerships or entities taxed like partnerships do not pay tax on their income, but file annual information returns. The information return reports income, deductions, gains, and losses of the business. Gains and losses are passed through to the owners, who report them on their returns.

## Take a number!

The Federal government keeps its records by using identification numbers. Taxpayers are commonly identified by Social Security Number (SSN), Taxpayer Identification Number (TIN), or Employer Identification Number (EIN). Except for Social Security numbers, these numbers are issued by the IRS. Businesses usually are required to obtain an EIN. An EIN is necessary if the business has employees, has a retirement plan or has to file returns.

## Tax Accounting

The fine points of tax accounting can be extremely complex ... and dry. The rules of tax accounting determine how much of your profit you get to keep, and how much must go to the IRS. To understand all the rules is a full-time job. However, you need to understand a few key concepts:

- Tax year;
- Accrual and cash methods of accounting;
- Inventory;
- Depreciation;
- Small business elections;
- Capitalization; and
- Expensing.

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**Planning tip.** A business's adherence to the generally accepted accounting principles may not guarantee that the IRS will determine that the particular method clearly reflects income for tax purposes. Taxpayers must make sure their books and records for tax purposes conform to tax accounting principles, and not merely to generally accepted accounting principles.

Differences between financial and tax accounting may arise because of the exclusion of certain economic accretion from gross income or the inability to deduct certain expenses for reasons such as lack of proper substantiation in tax accounting, or because income and deductions may be assigned to different periods for tax purposes and financial accounting purposes. Timing differences may also occur because tax rules require or permit income to be reported earlier than financial accounting permits (for example, prepaid interest) or later than financial accounting allows (for example, gain from installment reporting). In fact, tax principles sometimes can be in direct conflict with generally accepted accounting principles, such as in claim-of-right reporting, the use of reserves in certain cases or the write-down of excess inventory.

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## Financial versus tax accounting

Your *financial* accounting method may not be the same as your *tax* accounting method. Tax accounting is based on the tax law and regulations. These rules differ from accounting principles because of the social and economic incentives and policies built into the tax law and regulations.

**Paperwork overload?** If you use different methods for keeping books and tax accounting, you must keep records showing the reconciliation between book entries and their tax computations.

## Accounting Periods

### Tax year

Your taxable income is computed on the basis of a period called a “tax year.” A tax year is the annual accounting period on the basis of which you regularly compute income in keeping your books and records. The annual period is usually a calendar year or a fiscal year. Special rules exist if you:

- (1) Have no annual accounting period or keep no books and records;
- (2) Elect a 52 to 53-week fiscal year; or
- (3) Must file a return for a period that is less than 12 months (short-period return).

**Calendar v. fiscal year.** A calendar year is a period of 12 months ending on December 31. A fiscal year is a period of 12 months ending on the last day of any month other than December or a 52 to 53-week tax year. A *new* taxpayer may adopt either a calendar or a fiscal year when it files its first return.

Some generalizations about choosing a tax year:

- A business that has no annual accounting period and does not keep adequate records must compute taxable income on a calendar-year basis.
- A partnership generally must conform its tax year to the tax years of its owners unless the partnership can establish a business purpose for having a different tax year.
- An S Corp or a personal service corporation (PSC) must generally use the calendar year, unless it can show a business purpose for having a different tax year.

**52- or 53-week period.** You may elect to use a fiscal tax year that varies from 52 to 53 weeks if the period always ends on:

- The same day of the week (Monday, Tuesday, etc.);
- Either the last such day in a calendar month; or
- The closest such day to the last day of a calendar month.

Often, this type of arrangement makes it easier –and less expensive—to do a year-end “closing of the books.”

**Switching tax periods.** If you want to change from one accounting period to another, you generally have to secure permission from the IRS and file a return for the short period. You must show a substantial business purpose exists for making the change. If the sole purpose of the change is to maintain or obtain a preferential tax status, the IRS will deny it.

## Accounting Methods

### Cash v. Accrual

Taxable income must be computed not only on the basis of a fixed accounting *period*, but also in accordance with a *method* of accounting regularly employed in keeping your books. A “method of accounting” includes the overall method of accounting for income, expenses and special items such as depreciation.

There are two common overall methods of accounting for income:

- (1) Cash; and
- (2) Accrual.

**Cash method.** The cash method is the method of accounting used by most individuals. Income is reported in the year it is received. Income may be received in the form of cash, its equivalent or other property. Income not actually received, but within your control and without substantial restrictions, is said to be “constructively received.”

Under the cash method, deductions or credits are generally taken in the year in which the related expenditures are actually made. Some exceptions exist to prevent distortions in income reporting.

**Accrual method.** The accrual method accounts for income when the right to receive it comes into being. Expenses are deductible in the year in which they occur rather than the year they are paid. The rule is more complicated in practice and is qualified by when economic performance actually occurs.

**Caution.** The use of multiple accounting methods is *not* permitted if they create or shift profits or losses between a taxpayer’s various trades or businesses.

### Small business exception

The IRS prefers that you use the accrual method and until recently many small businesses were forced to switch from the cash method to the accrual method. New regulations, however, now ease the rules for businesses with annual gross receipts of \$10 million or less.

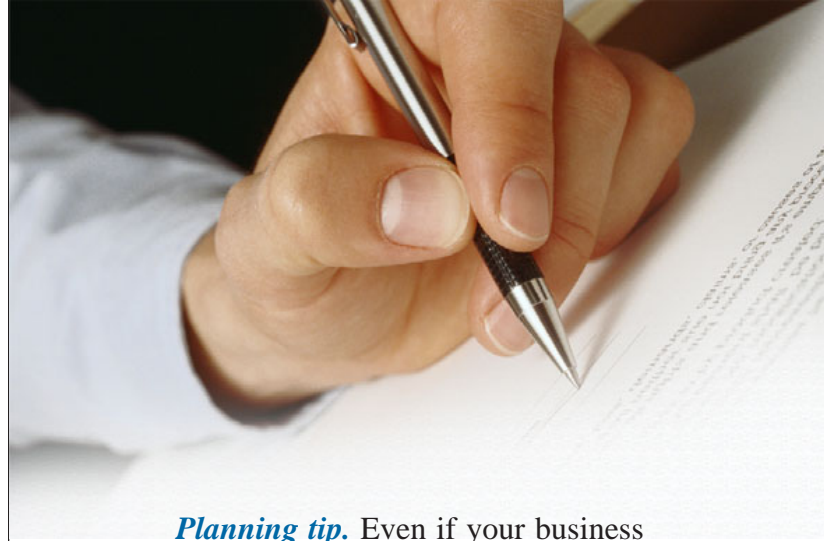
If your annual gross receipts are less than \$10 million, you may be able to use, without prior IRS approval, one of three optional methods of accounting:

- The overall cash method of accounting using inventory accounting;
- The overall accrual method of accounting with accounting for inventory items as non-incidentals supplies; and
- The overall cash method of accounting with accounting for inventory items as non-incidentals supplies.

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The limit for automatically switching to the cash method is \$10 million in annual gross receipts. You can meet this test by averaging your gross receipts over the past three years if last year's gross receipts were more than \$10 million.

**Exceptions.** Not every small business can take advantage of the relaxed accounting rules. The



**Planning tip.** Even if your business as a whole cannot use the cash method, depending on how your business is structured, part of it may be able to use the cash method even if another part cannot.

exceptions are broad and complex. You need to talk to your tax advisor. Some businesses, such as mining or manufacturing, are specifically excluded from the new rules.

### Income Recognition

**Deferred income.** Payments received in advance are treated as income in the year of receipt. This is true even though the payments are returnable upon the happening of some specified event. A distinction must be made, however, between prepayments and deposits.

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Inclusion in the year of receipt is required for amounts that are paid for future services. However, the IRS has set up a special procedure to permit the deferral of prepayments for future services by accrual-basis taxpayers until the time of performance.

**Example.** A dance studio receives advance payment for 48 dancing lessons under a one-year contract on November 1, 2005. Eight lessons are given in 2005. The remaining lessons are taught in 2006. If the dance studio elects the deferral method, 1/6 of the payment is included in income in 2005 and 5/6 of it is taxable as 2006 income, even if not all of the remaining 40 lessons are not actually given in 2006.

### **Need for inventories**

The use of inventories at the beginning and end of each year is required in most every case where the production, purchase or sale of merchandise is an income-producing factor. Inventories must also be used wherever necessary to clearly reflect income.

A taxpayer whose average annual gross receipts do not exceed \$1 million is generally not required to use inventories or the accrual method of accounting.

### **Accelerating or deferring income**

You can accelerate or defer income and potentially lessen harsh tax consequences. Here are some examples:

- Billing for services or products can be accelerated and payment received before the end of the year.
- Dividends can be paid before the end of the year or delayed until the next year.

- Self-employed individuals can delay billing until late in the year so payments will not be received until the next year.
- Year-end bonuses can be delayed.
- Special accounting rules also can help you defer recognition of gain, such as an employee's taxable fringe benefits.

Timing business purchases has very important tax consequences. Depreciation generally runs on half-year conventions and you need to decide whether to make your purchase in the last months of the year or if deferring it until the next year will help minimize taxes. Small businesses can "write-off" (expense) rather than depreciate property placed in service (up to \$100,000 each year in 2003-2007 adjusted for inflation. The inflation-adjusted maximum was \$105,000 for tax years beginning in 2005 and is \$108,000 for 2006).

### **Business expenses**

Some expenses can be deducted immediately and others must be recognized over time. The rules are complex and controversial.

Generally, you may immediately deduct ordinary and necessary business expenses in the year they are paid or incurred under

your method of accounting. Capital expenditures are added to your tax basis and recovered through depreciation or amortization deductions.

To be immediately deductible, an expense must be an ordinary and necessary expense in relation to your trade or business. An expense generally must be reasonable in amount to meet the ordinary and necessary test.

The cost of capital expenditures – generally items of lasting value that are not purchased each year—cannot be immediately deducted. Some are deducted gradually over their “useful lives.” Others are deducted from the price at which they are eventually sold for purposes of determining taxable gain.

## Depreciation

You may deduct a reasonable amount for the exhaustion, wear and tear of property used in your business. This deduction allowance is called depreciation. Various methods of depreciation apply depending upon your business and the date the property is placed in service.

**Methods.** The methods of depreciation are dependent upon when the property was placed in service:

- The Modified Accelerated Cost Recovery System (MACRS) applies to

tangible property generally placed in service after 1986.

- The Accelerated Cost Recovery System (ACRS) applies to property placed in service after 1980 and before 1987.

Personal property is usually depreciated using the half-year convention under MACRS, which allows you to claim one-half of a full year’s depreciation in the year you purchase an asset. However, you are subject to the mid-quarter convention if the total cost of personal property that you place in service during the last three months of the year exceeds 40 percent of the total cost of all personal property placed in service during the year.

**Depreciation bonus.** You may be able to claim “bonus depreciation.” After 9-11, Congress created a special 30 percent depreciation allowance for property acquired after September 10, 2001 and before September 11, 2004. Congress wanted to encourage businesses to invest in new equipment. In 2003, Congress boosted the bonus to 50 percent for property acquired after May 5, 2003 and placed in service before January 1, 2005. Bonus depreciation was again reinstated for investments made on or after August 28, 2005, with respect to Katrina “GO Zone” property.

You should use the accounting period and method that results in the quickest recovery of the cost of the asset. However, if you are in a low tax bracket and anticipate moving to a higher bracket, it may be advantageous to elect a MACRS method and recovery period that delays your deductions, such as the MACRS alternative depreciation system (ADS). In fact, many businesses must keep three sets of books on certain assets: depreciation basis for federal income tax, federal AMT and state tax.

### Section 179 expensing

Each year, most small businesses can immediately deduct property that otherwise would have to be depreciated. The election, which is made on Form 4562, is attached to your original return. You may not expense every cost. Section 179 expensing has some important limitations. They are:

- *Dollar amount.* The maximum deduction is \$100,000, inflation adjusted (\$105,000 in 2005, \$108,000 in 2006).
- *Investment ceiling.* The dollar amount is reduced dollar for dollar of the cost of property placed in service during the tax year over \$400,000 inflation adjusted (\$420,000 in 2005, \$430,000 in 2006).
- *Taxable income.* The total cost that may be expensed

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**Planning tip:** Generally, the mid-quarter convention results in less overall depreciation than the half-year convention. However, if you are able to time the purchase of your assets, you may be able to get an increased depreciation deduction using the mid-quarter convention in the first year of the depreciation period. The mid-quarter convention produces the best potential for tax savings when assets with the shortest recovery periods and highest costs are placed in service during the first quarter.

for any year cannot exceed the total amount of taxable income derived from your business, including salaries and wages.

- *Special “zones.”* Even more generous expensing incentives are available for investment in the New York Liberty Zone, in an empowerment zone, renewal community, or in a Katrina disaster area.

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### Handling Losses

A business loss may be deducted if it is not compensated for by insurance or in another way. Losses that occur when investment or business property is sold, damaged,

destroyed, abandoned, or becomes worthless are generally deductible in the year of occurrence (unless there is a reasonable prospect of recovery). Theft loss is sustained in the year of discovery. The amount of loss attributable to any business property may not exceed the adjusted basis of the property.

**Example.** Your business lost five percent of its sales inventory to shoplifting last year. The deduction for that loss is the cost of the inventory to your business, and not the price at which it was marked for sale. If the lost property had been depreciated property, your deduction is the amount of your basis.

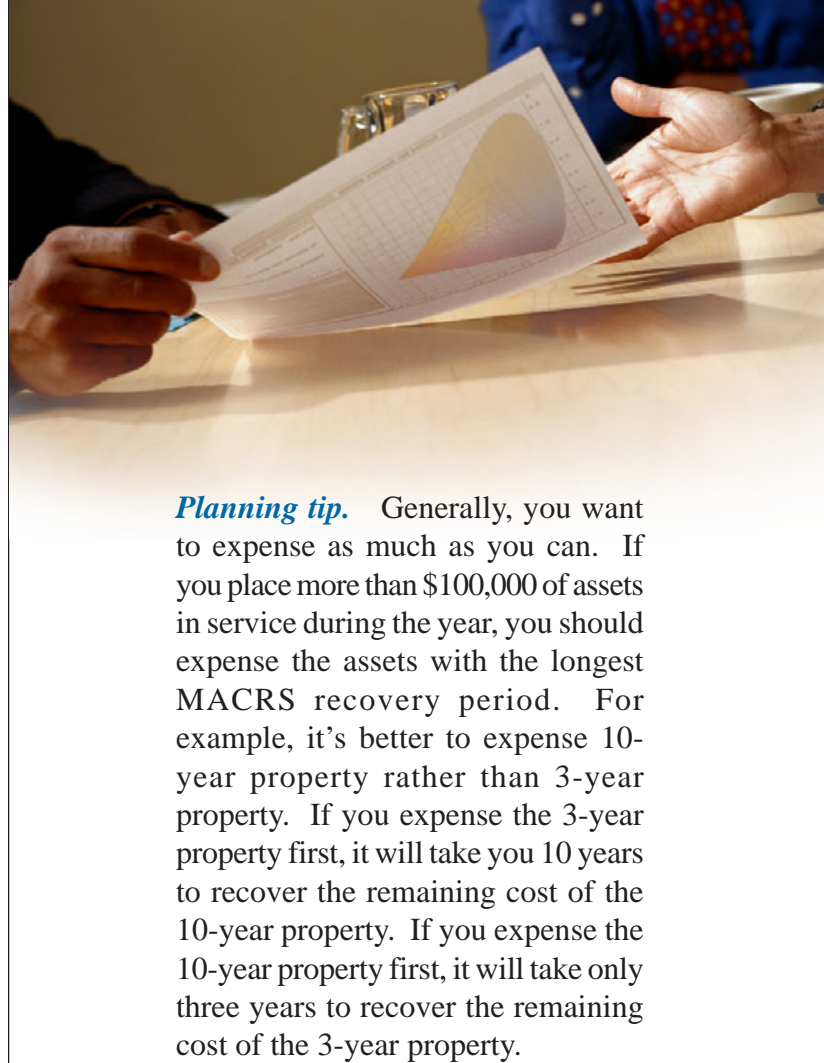
### Passive losses

Personal service corporations and closely held C corporations may only deduct passive activity losses from passive activity income. Passive activity is trade or business activity in which a taxpayer does not materially participate.

Rental activity is usually passive activity, except for real estate professionals and others providing services and short-term rentals.

Deductions and credits that are disallowed under passive activity rules may be carried forward and used as passive activity deductions and credits in succeeding years. Remaining passive activity deductions are deductible against non-passive income when a taxpayer disposes of the passive activity.

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**Planning tip.** Generally, you want to expense as much as you can. If you place more than \$100,000 of assets in service during the year, you should expense the assets with the longest MACRS recovery period. For example, it's better to expense 10-year property rather than 3-year property. If you expense the 3-year property first, it will take you 10 years to recover the remaining cost of the 10-year property. If you expense the 10-year property first, it will take only three years to recover the remaining cost of the 3-year property.

### Net Operating Losses

Generally, a net operating loss (NOL) is created if your deductions exceed gross income. You may be able to carry back or carry over the NOL to another tax year.

Most NOLs can be carried back two years. Some NOLs can be carried back three years. They include:

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- Casualty and theft losses; and
- NOLs of small business taxpayers and farmers attributable to Presidentially declared disasters.

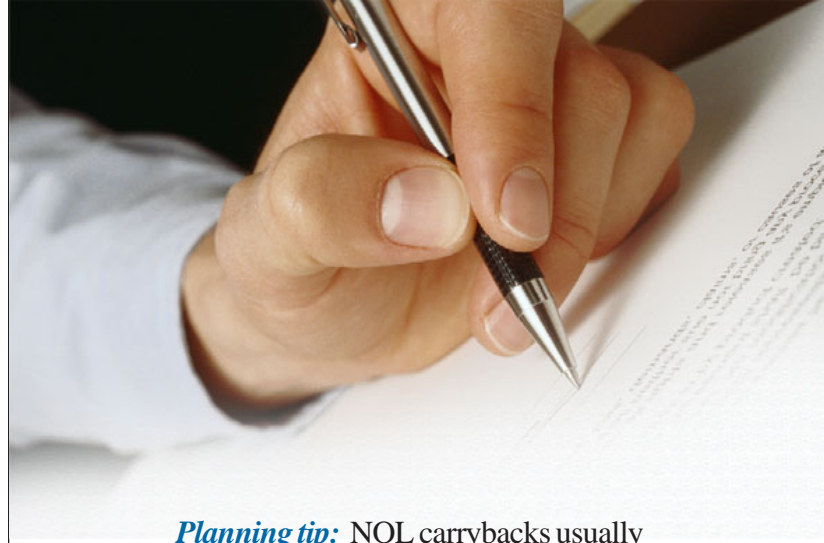
An NOL can be carried forward for 20 years. The entire NOL is carried to the earliest year and, if not completely used, is applied to succeeding years until it is used up or expires.

**Special five-year carryback.** As part of post-9-11 relief for the economy, NOLs arising in tax years ending in 2001 and 2002 can be carried back five years. The carryback is automatic. If you don't want to carry back NOLs five years, you have to make a special election to waive the five-year period.

The carryback rules are very strict. To help businesses, Congress has clarified the rules in the *Working Families Tax Relief Act of 2004*. Only NOLs from 2001 and 2002 qualify for the five-year carryback.

### Section 1231 losses

“Heads I win, tails you lose” is not a tax concept often followed by the IRS. But “Section 1231” is the exception. Business real estate, or any depreciable business property, is excluded from the definition of “capital assets.” For tax accounting, however, if the business property qualifies as “section 1231 property” and gains from dealings in such property exceed losses, then each gain or loss is treated as though it were derived from the sale of a long-term capital asset. If the losses exceed the



**Planning tip:** NOL carrybacks usually present an opportunity for an immediate tax refund since income previously taxed in a carryback year now may be offset by the NOL. Either an amended return or use of a “quick refund” procedure is usually in order. Although the election not to take advantage of either the two-year or the extended five-year carryback rule could mean postponement of the NOL deduction, electing to waive the benefit of the new rule can make sense for some taxpayers.

gains, on the other hand, all gains and losses are treated as though they were ordinary gains and losses.

### Business Credits

Business credits directly reduce your tax liability for the year, dollar-for-dollar, making them even more valuable than deductions. Tax accounting rules, however, make this direct offset against tax liability complicated, with exceptions and exceptions-to-exceptions that can change the timing of an incidence of tax and complicate its calculation.

The calculation of business credits is complex. Claiming credits could have adverse consequences, like incurring AMT liability. To maximize the value of the business credits, you need the help of your tax advisor.

### Here are some business credits:

- Investment credit;
- Work opportunity credit;
- Alcohol fuels credit;
- Research credit;
- Low-income housing credit;
- Enhanced oil recovery credit;
- Disabled access credit;
- Orphan drug clinical testing credit;
- Renewable electricity production credit;
- Credit for unused payments to Trans-Alaska Pipeline Fund;
- Empowerment zone employment credit;
- Indian employment credit;
- Credit for contributions to community development corporations (CDCs);
- Welfare-to-work credit;
- New markets credit;
- Small employer pension plan startup cost credit; and
- Employer-provided child care credit expenses.

The *Energy Tax Incentives Act of 2005* contains several new business credits:

- Credit for constructing energy-efficient new homes;
- Credit for manufacturing energy efficient appliances;
- Credit for installing “qualified fuel cell power plants”;
- Renewable electrical energy credit;



**Planning tip.** Timing section 1231 gains and losses makes a substantial difference in your tax rate. The rule, however, is riddled with exceptions. For example, a loss that is disallowed by other provisions of the law (for example, a sale between family members) is not taken into account in comparing section 1231 gains and losses.

- Qualified clean fuel vehicles credit;
- Credit for producing fuels from “nonconventional sources”;
- Biodiesel fuels and ethanol credit;
- Nuclear power plants credit; and
- Energy research credit.

**Caution.** Many of these credits are temporary. Some expire at the end of 2006. Be sure to talk to a tax professional before claiming any of these credits.

### Recordkeeping

What would a summary of tax accounting principals relevant to your business be without ending on a review of some bookkeeping requirements? Put on your green eyeshades and take a look at some of the paperwork that may be required of your business (or the next one you plan to start) as “an employer.”

**Self-employment tax.** Generally, every individual, other than a nonresident alien, who has net earnings from self-employment of \$400 or more for the tax year must file a self-employment tax return on Form 1040, Schedule SE.

**Employment taxes.** Records required under the employment tax regulations must be accurate and sufficient to ascertain liability for tax, but do not have to be in any particular form. Employment tax records must be kept at one or more convenient and safe locations and must be available for inspection by the IRS.

Every employer subject to Social Security tax must keep specified records of all remuneration, whether or not paid in cash, paid to employees for services, except agricultural labor or domestic services. Employers liable for federal unemployment taxes must also keep specified records.

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Employers who withhold income tax or Social Security tax, or both, from their employees' wages are required to file at least *quarterly returns* on Form 941 to report the amount of tax withheld and their share of Social Security tax. Employers with large payrolls are required to deposit taxes as often as every three or four days.

**Federal Unemployment Tax (FUTA).** FUTA is not withheld from employees' wages. It is paid by the employer. Employers report the tax on Form 940, Employer's Annual Unemployment Tax Return.

Generally, you have to deposit employment taxes, certain excise taxes, corporate income tax and S Corp taxes before you file a return. Some taxes may be deposited at an authorized financial institution. If your total deposits of withheld Social Security, Medicare and income taxes exceed certain limits, you have to use the Electronic Federal Tax Payment System.

## **The End . . . But Don't Forget**

Understanding the ins and outs of tax accounting probably was not what you planned to do when you started your business. It is a specialized area where your tax professional can help you make your business more profitable. Application of the correct tax accounting method is essential to your bottom line.

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