OPERATING A BUSINESS

TAX CONSIDERATIONS

Wolters Kluwer

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 booklet 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 to the extent allowed by law.

THE BIRD'S EYE VIEW

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.

The bottom line: Regardless of whether you chose to operate your business as a sole proprietorship, partnership, limited liability company (LLC), limited liability partnership (LLP), S Corporation (S corp), or C Corporation (C Corp), the business must have a separate set of accounts from you. 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.

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 retained 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.

- A sole proprietor must file Form 1040 Schedule C, Profit or Loss From Business (Sole Proprietorship);
- Corporations file Form 1120 or 1120S, calculate estimated tax payments with Form 1120-W, and pay the taxes electronically;
- Partnerships and many LLCs with more than one owner file Form 1065.

Planning Tip. Depending on the size of your business, you may be required to file your return(s) electronically.

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 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. 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.

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 financial accounting principles because of the social and economic incentives and policies built into the tax law and regulations.

> ***Caution.*** 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 year 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.); and
- Either the last such day in a calendar month; or
- The closest such day is 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 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 versus accrual method

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.

Although the cash method is fairly simple to apply, not all businesses are able to use it. C corporations, partnerships with a C corporation as a partner,

and some trusts generally must use the accrual method instead. However, an exception to this requirement applies for small businesses with average annual gross receipts of $5 million or less, farming businesses and qualified personal service corporations.

In addition, most taxpayers that maintain inventories, other than certain small businesses (see below), cannot use the cash method.

Accrual method. Under the accrual method, items are included in gross income when (1) all events have occurred that fix the taxpayer's right to receive the income and (2) the amount can be determined with reasonable accuracy. Or in other words, revenue is generally counted when a business delivers its products or performs its services, and not when it receives actual payment for them. Similarly, by using the accrual method, businesses are often able to deduct their expenses, such as debts, in the year in which they are incurred, even if the business does not pay them until later.

Accounting for revenue and expense is much more complicated in practice. For example, businesses engaged in the sale of goods must keep records of their inventory. In such cases, they may use one of several other accounting methods to determine the cost of their items of inventory and the price at which they were sold. Use of the "last-in, first-out" (LIFO) method of accounting has been a subject

of debate in recent years, as it has enabled sellers to take advantage of inflated prices by selling more expensive, more recently acquired items first and valuing their remaining inventory by using earlier, lower prices.

■ ***Planning Tip.*** Among the various legislative proposals currently before Congress is one that would prohibit taxpayers from using the last-in, first-out (LIFO) method of accounting. Another proposal would impose more restrictions on the use of the cash method. Both proposals face opposition from the private sector.

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. If a taxpayer must maintain inventories, then the taxpayer

generally must use the accrual method as their overall method of accounting, unless they qualify for one of the small business exceptions below.

Small business exception

The accrual method is generally the required accounting method for C corporations, larger businesses, and businesses that keep inventories. However, the IRS allows smaller businesses that keep inventories to use the cash method or a simplified version of the accrual method instead.

Under one exception, a small business with inventories that has average annual gross receipts of $1 million or less is generally not required to use the accrual method of accounting. Merchandise inventory can, instead, be treated as a non-incidental material or supply.

Under a second exception, a small business with inventories that has average annual gross receipts of $10 million or less and is one of the specified eligible trades or businesses is generally not required to use the accrual method of accounting. Merchandise inventory can, instead, be treated as a non-incidental material or supply.

Exceptions. Not every small business can take advantage of the relaxed accounting rules. The exceptions are broad and complex. You need to talk to your tax advisor to find out if your business qualifies.

CHANGE IN ACCOUNTING METHOD

Before a taxpayer makes a change in its method of accounting, it generally must secure the consent of the IRS. The agency has issued procedures for taxpayers to follow when a taxpayer seeks to change an accounting method voluntarily. Many changes in accounting method required by law are covered by a special IRS procedure which automatically grants the IRS' consent to the change.

> ***Comment.*** Rev. Proc. 2011-14 describes the procedures taxpayers may use to obtain automatic consent for a change in method of accounting listed in the procedure. The procedure is updated periodically to add new areas and remove other areas from the list of automatic consent changes.

INCOME RECOGNITION

Deferred income. Payments received in advance are treated as income in the year they were received. 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.

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.

Accelerating or deferring income

You may be able to accelerate or defer income and potentially lessen harsh tax consequences. Here are some examples:

- Billing for services or products can be accelerated so payment is 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 can help you defer recognition of gain.

You might also be able to accelerate or defer certain deductions for your business costs. For example, you may be able to decide whether to make a purchase in the last months of the year, or whether deferring it until the next year will help minimize taxes.

COST RECOVERY

Some business costs can be deducted immediately and others must be recognized over time. These rules can be very complex.

Generally, you may deduct ordinary and necessary business expenses in the year they are paid or incurred under your method of accounting. In contrast, capital expenditures are added to your tax basis and recovered through depreciation or amortization deductions. However, Code Sec. 179 allows certain capital expenditures to be deducted immediately.

Section 179 expensing

Under Code Section 179, small businesses can "write-off" (expense) rather than depreciate property that would ordinarily have to be capitalized.

Total 179 expense deductions are limited to $500,000 in 2013; this cap is scheduled to drop to $25,000 in 2014. The limit is reduced for larger taxpayers that place at least $2 million in qualified property in service during 2013 ($200,000 in 2014). Your total 179 deduction also cannot exceed your taxable trade or business income for the year (plus your spouse's trade or business income, if you file a joint return). Qualified property must be used at least 50 percent in your trade or business. The deduction and limits are reduced in proportion to the nonbusiness

use of the property. Section 179 applies to most depreciable property, but it generally does not apply to most buildings, air conditioners and heating units.

For 2013, Code Sec. 179 expensing also applies to up to $250,000 in costs to purchase depreciable qualified real property. Qualified real property is qualified leasehold improvements, qualified retail improvement property, and qualified restaurant improvement property.

As a safety valve, a business may opt out of expensing qualified real property if it is better off otherwise maximizing expensing. The law also provides for limits on the carryover of qualified real property deductions.

Business expenses

Generally, you can deduct your ordinary and necessary business expenses in the year they are paid or incurred. An ordinary expense is one that is customary or usual within the practice of a particular business community. An expense is necessary if it is appropriate and helpful for the development of your business. An expense generally must be reasonable in amount to meet the ordinary and necessary test.

Capital expenses

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.

Sometimes, the distinction between business expenses and capital expenditures is relatively easy to see. For example, the uniform capitalization (UNICAP) rules generally require you to capitalize the cost of trade or business property you produce or acquire for resale. Of course, there are many exceptions to UNICAP.

One place where it is often difficult to distinguish business expenses from capital expenses is when business property is repaired or improved. Basically, repair and maintenance costs are deductible business expenses, while costs to improve property must be capitalized.

The IRS issued a comprehensive set of proposed and temporary rules, commonly called the "repair regs," at the end of 2011. These regulations were largely finalized in 2013, to take effect on January 1, 2014. For earlier tax years, taxpayers can rely on the final regulations or the earlier sets of proposed and temporary regulations. The regulations are far-reaching, applying to every business that uses tangible property. They provide a more explicit framework for determining capital expenditures, as well as some simplifying conventions, such as the deduction of materials and supplies.

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. The particular method of depreciation depends on your business and the date the property is placed in service.

The Modified Accelerated Cost Recovery System (MACRS) applies to tangible property placed in service after 1986. The Alternative Depreciation System (ADS) must be used for some MACRS property, such as property used outside the United States and property leased to tax-exempt entities. Taxpayers can generally elect to use ADS for other MACRS property. Property placed in service before 1987 is depreciated under the Accelerated Cost Recovery System (ACRS). Generally, MACRS is more generous to taxpayers than ACRS.

> **Comment.** There are special depreciation rules for certain improvements to restaurants and retail property.

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 the property. 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.

> **Comment:** You should use the depreciation 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 ADS. In fact, many businesses must keep three sets of books on certain assets: depreciation basis for federal income tax, federal alternative minimum tax (AMT) and state tax.

Bonus depreciation. Property acquired and placed in service during 2013 can qualify for a 50-percent bonus depreciation allowance. The placed-in-service deadline is extended through 2014 for property with long production periods and certain noncommercial aircraft.

This means that you can immediately depreciate (deduct) up to 50 percent of the cost of qualified property, regardless of what month during 2013 it was placed in service. There is no annual limit on the bonus deduction, and no dollar amount, taxable income, or investment limits for eligible taxpayers. However, bonus depreciation does not apply to property that must be depreciated under the alternative depreciation system (ADS). ADS must be used for "listed property," including most

vehicles that are used less than 50 percent of the time for business purposes.

You can elect to take additional alternative minimum tax (AMT) credits in lieu of bonus depreciation for certain property.

Bonus depreciation must be claimed for both regular tax and alternative minim tax (AMT) liability unless the taxpayer makes an election out. Once made, an election out cannot be revoked without IRS consent.

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 the loss occurs, unless there is a reasonable prospect of recovery. A theft loss occurs in the year the theft is discovered. 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. Your deduction for that loss is the cost of the inventory to your business, rather than its sales price. If the lost property was depreciated property, your deduction is the amount of your basis.

Passive losses

Personal service corporations and closely held C corporations may deduct passive activity losses only from passive activity income. A passive activity is trade or business activity in which a taxpayer does not materially participate. You materially participate in your business if you are involved in its operations on a regular, continuous and substantial basis.

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

Net operating losses

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

Most NOLs can be carried back two years. However, in some circumstances, particular NOLs may be carried back as long as five years. Generally, a taxpayer can elect to waive the applicable carryback period and carry the entire NOL forward.

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.

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.

Section 1231 applies to gain or loss on the disposition of business property, based on the distinction between capital gain/loss and ordinary income and loss. Basically, the tax rate on ordinary income is higher than the rate on capital gains, but capital loss deductions are limited. Section 1231 provides a very taxpayer-friendly twist on these rules:

- Gain on Section 1231 property is taxed as long-term capital gain (so the tax rate is much lower than it is for earned income)
- Loss on Section 1231 property is treated as ordinary (so it is not subject to the restrictions on capital loss deductions).

Section 1231 property includes business real estate and depreciable business property held for at least one year, as well as certain capital assets that are involuntarily converted.

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 a tax and complicate its calculation.

The calculation of business credits is complex. Claiming credits can even 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
- Research credit
- Low-income housing credit
- Disabled access credit
- Historic rehabilitation credit
- Energy credit
- Renewable electricity production credit

- Indian employment credit
- New Markets Credit
- Pension plan start-up costs credit
- Employer child care expense credit
- Employer's military differential pay credit
- Small Employer Health Insurance Credit.

Small employer health insurance credit. The small employer health insurance tax credit is relatively new. For 2013 an eligible small employer may claim a 35 percent tax credit (25 percent if the employer is tax-exempt) for premiums it pays toward health coverage for its employees. After January 1, 2014, the maximum credit amount increases to 50 percent of premiums.

An eligible small employer may have up to 25 full-time employees, as long as average annual employee compensation is no more than $50,000. However, the credit is reduced if the employer has more than 10 employees or pays average annual employee compensation of more than $25,000.

Special carryback relief. Most of the credits listed above are components of the General Business Credit. When a taxpayer's total General Business Credits exceed income, the excess can generally be carried back for one year and forward for 20 years.

RECORDKEEPING

What would a summary of tax accounting principles 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, you must file a self-employment tax return on Form 1040, Schedule SE, if you earn more than $400 in self-employment income for the year.

> **Comment.** A self-employed individual can claim an income tax deduction for qualified health insurance premiums, but this deduction does not reduce self-employment income.

Employment taxes. If you have employees, you must keep records that are accurate and sufficient to ascertain your liability for employment taxes. However, your records 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.

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

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, and corporate income tax and before you file a return. Unless you have a quarterly employment tax liability of less than $2,500, you must make your deposits through the Electronic Federal Tax Payment System (EFTPS).

CONCLUSION

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.