



2005

Small Business

advisor

TIMELY TALK ABOUT BUSINESS, TAXES AND TRENDS

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INSIDE THIS ISSUE:

- Tax Calendar
- Shift Business Income to Lower Taxes
- Thinking About Incorporating?
- Where Are You Financially?
- Knock, Knock: It's the IRS!
- Do I Need a Business Plan?
- Questions & Answers



Shift Business Income to Lower Taxes

If you have children that can work for you on a part-time basis or during the summer, you may be able to turn high-taxed income into tax-free or low-taxed income. It may even be possible to save on social security taxes and make retirement contributions for your child.

The work that the child performs must be legitimate and the compensation must be reasonable for your business to deduct the wages as a business expense. Take for example, a sole proprietor in the 35% tax bracket who hires her 16-year-old son to help with office work full-time in the summer and part-time in the fall. He earns \$5,000 during the year and has no earnings from other sources. Since her son can use his \$5,000 standard deduction for 2005 to completely shelter his earnings, the business owner saves \$1,750 (35% of \$5,000) in income taxes without costing her son a penny.

If the business owner keeps her son on the payroll for a longer period of time and pays him \$4,000 more, she could save an additional \$1,400 in taxes, and still not cause her son to pay any tax, provided he contributes \$4,000 to a traditional IRA. Even if her son's earnings exceed his standard deduction and IRA deduction, her taxes are cut because the unsheltered earnings will be taxed to the child, whose tax bracket starts at a rate of 10%.

The business will probably have to withhold federal income taxes on the child's wages. An employee is generally allowed to claim exempt status if he or she had no federal income tax liability in the previous year and does not expect any this year. Keep in mind that exemption from withholding cannot be claimed if:

- the employee's income exceeds \$800 and includes

more than \$250 of unearned income (such as dividends), and

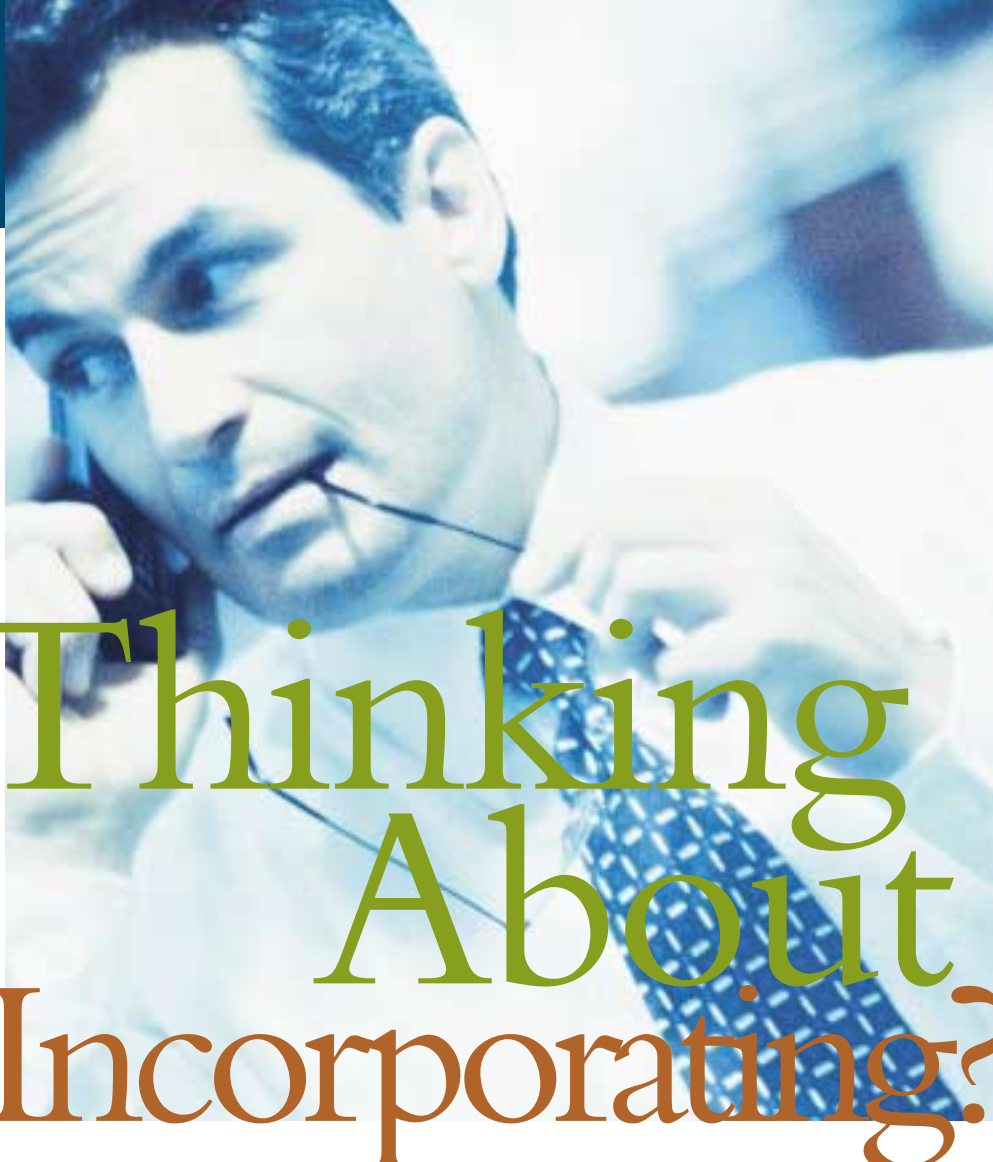
- the employee can be claimed as a dependent on another taxpayer's return.

When your child files a return for the year, he or she will probably receive a refund for part or all of the withheld tax.

By shifting some of your earnings to your child, you can also save some self-employment (SE) tax dollars if your business is not incorporated. This is because wages paid to the child are part of the business expenses and reduce your net income on which SE tax is based. However, you will not have a deduction for the employer's portion of FICA tax on the child's wages since you will not have paid this tax. Employment for FICA tax purposes does not include services performed by a child under the age of 18 while employed by a parent. A similar but more liberal exemption applies for FUTA, which exempts earnings paid to a child under age 21 while employed by his or her parent. Both the FICA and FUTA exemptions also apply if a child is employed by a partnership consisting solely of his or her parents.

In addition to the potential tax savings of bracket-shifting, your business may also be able to provide your child with retirement benefits. This depends on the type of plan your business has and how it defines qualifying employees.

Take into consideration that some of the rules about employing children change on a yearly basis, which may result in some strategy shifts as well. Please call our office to find out if these rules apply to your situation.



Thinking About Incorporating?

The decision on whether or not to incorporate involves a number of complicated issues. All too often, taxpayers make unwise decisions based on misconceptions of tax benefits available to corporate entities. It is not uncommon at social gatherings to overhear someone talking about incorporating in order to write off this or that. Generally, there is little difference between expenses that are deductible as an individual doing business versus that of a corporation. Although there are some benefits associated with corporations, there are also corresponding negatives. Corporations can take two forms, either a C-corporation or an S-corporation. To gain some insight into the differences between doing business as a corporation or as an individual, let's review some of the major issues:

Limited Liability – A corporation is an entity unto itself. The shareholder owns an interest in the corporation itself but does not own an interest in the corporation's individual assets. Except in unusual circumstances, a shareholder's liability is generally limited to his or her investment in the corporation. This is a distinct advantage over an individual doing business, in which both the business and personal assets are at risk.

Double Taxation – Generally, the only way money can be taken out of a corporation is via a reasonable salary, through dividends paid by the corporation, or reasonable interest on stockholder corporate debt. The wages and interest are both deductible to the corporation, but the dividends are not. Thus, there is a potential for double taxation: the stockholder pays individual income tax on the dividends received but the corporation is not allowed to deduct the dividends paid as an expense. If the corporation has a loss for the year, the stockholders (except for S-corporation stockholders) receive no benefit. In contrast, an individual doing business reports on his or her personal tax return the business' overall gain or loss for the year, and there is never any risk of double taxation. In addition, the individual benefits from a deduction against other income if the business has a loss for the year.

Employee Fringe Benefits – There are a number of fringe benefits available to corporate employees that are not available to or are significantly different for individually-owned businesses. Some of the more popular benefits include pension/profit-sharing plans, group life insurance, group health insurance, disability income coverage, medical reimbursement plans, cafeteria plans and education reimbursement plans. However, shareholders/employees of S-corporations do not receive the full range of tax-free fringe benefits that are available to those of a C-corporation.

Selling the Business – Generally, selling an individually-owned business involves putting up for sale the various pieces that make up the business

such as equipment, real property, goodwill, etc. The business owner is taxed on each piece based on the remaining cost in that item and can sometimes take advantage of the lower capital gains rates. This is also mostly true for S-corporations that sell off the pieces of the business rather than the stock, since they are "pass through" entities. For a corporation, the business can be sold by simply selling the shares of stock to a buyer, resulting in a capital gain (or loss) to the seller. However, in most cases, the buyer prefers an asset purchase, which provides better up-front write-offs and avoids assumption of any prior corporation liabilities. When this happens, the sale of the asset is taxed at the corporation level and will generally be taxed again at the personal level in the form of a dividend, salary or liquidation.

Administrative Costs - Establishing and maintaining a corporation can be costly. Normally, a lawyer handles the filing of the Articles of Incorporation and states charge for issuing corporate charters. In addition, the corporation must pay yearly fees to maintain its charter and conduct its business. The corporation must maintain a list of all the shareholders and hold at least one shareholder meeting per year, both of which add to its corporate expenses. In contrast, the business operating as an individual does not have these expenses.

Avoid leaping into business structures until you have thoroughly educated yourself and reviewed your options, including exit strategies, retirement plan options, and a whole host of other considerations based on the type of business, business partners, potential liabilities, investment required, estate issues, etc. Please call this office before making your final decision.

Knock, Knock: It's the IRS!

If your business is under scrutiny by the IRS, expect a thorough investigation of your life, not just your tax return. These are a few issues that they will more than likely look into:

- 1) If your business handles a lot of cash, the IRS will assume that you pocket that money without declaring it on your tax return.
- 2) Does your lifestyle match your reported income? If you are living like Donald Trump but have the income of a construction worker, flashing red lights will go off with the IRS.
- 3) Are you documenting all of your travel and entertainment deductions? The IRS knows that this is a frequent area of abuse. Avoid claiming personal entertainment, meals or vacation costs as business expenses.
- 4) Employment taxes are another big item on the list. Make sure you are filing payroll tax returns and making timely tax payments if you have employees.
- 5) Claiming a personal expense as a business one is quite common, whether it is done intentionally or by mistake due to sloppy recordkeeping. If the amount is significant enough, the IRS will call you on it.
- 6) Another major item on the IRS list is independent contractors. They know that businesses enjoy the tax savings derived from hiring an independent contractor versus an employee. If the worker should really be classified as an employee and not as an independent contractor, the IRS will attempt to assess additional tax and significant penalties on the employer.

These are just a few things that the IRS watches out for during an investigation. Please contact our office if you are concerned about incurring penalties or having to answer to the IRS.

Do I Need a Business Plan?

Business plans are used primarily for raising capital and guiding growth. Not everyone who starts and runs a business begins with a business plan, but it certainly helps to have one.

If you are seeking funding from a venture capitalist, bank, or other lending institution, a comprehensive business plan that demonstrates sound business reasoning will help you negotiate through the funding process. The business plan will convince investors that your new venture is worth funding, that you have identified an opportunity and have gathered the management and organization needed to be successful.

A well-written business plan is the best way to show investors that you deserve their financial support. Make sure that your plan is clear, accurate, focused and realistic. Use it to convince prospective investors that you have the tools, talent and team to build and run a successful business.

A business plan can be a valuable tool in analyzing all aspects of your business as it grows. Since most business owners are in fact learning on the job, a business plan takes this information and analyzes different possibilities without the risk and cost of working them out in real time. A variety of marketing or pricing scenarios can be played out on paper before testing even occurs.

The business plan helps focus the entrepreneur by:

- defining objectives and detail programs to achieve forecasted results.
- creating a regular business review and course correction process.
- evaluating a new product line, promotion or growth opportunity.
- analyzing the quality of staff and future staffing needs.
- clarifying financial requirements and cash flow forecasts.
- refining strategy when making difficult decisions.
- determining the strength of the competition and analyzing market trends.

Understanding where your venture is heading can determine whether or not you need to plan. Your business plan can help you work smarter, anticipate the future, test ideas and create a results-oriented organization.

Where Are You Financially?

When it comes to your health, you see a doctor to make sure that you are physically fit. The medical report will indicate any health issues. You should be equally concerned about your financial health and check up on it regularly.

In order to set your financial goals, you need to know where you are on the financial scale. There are two financial statements that can be used to determine your financial fitness:

1) Income Statement – Otherwise known as the profit and loss statement, the income statement is divided into two sections: the monthly income and expenses.

- **Income:** These include your salary, rental income, stock and bond dividends, interest from savings accounts and royalties.
- **Expenses:** These include items such as food, clothing, mortgage and credit card payments, utilities, medical expenses, charitable donations, taxes and education.

List these items under their respective categories and then calculate your total income and expenses. Once you have that amount, calculate your net income. Your net income is the difference between your gross income and expenses. If

you come up with a negative net income, you are spending more money than you make. You will have to reduce your spending or increase your income.

2) Balance Sheet – The balance sheet also consists of two sections: assets and liabilities.

- **Assets:** These items include cash, real estate property, car, bank and investment accounts and businesses.
- **Liabilities:** These include your mortgage, loans (credit card, car, education and personal) and taxes.

List your assets and liabilities under their respective categories and calculate the total for each. The next step is to calculate your net worth, which is the difference between your total assets and total liabilities. Your net worth will determine if you fall among the wealthy.

These are just a few steps you can take to ascertain your level of financial fitness. This will allow you to take the necessary measures to achieve financial freedom. Start taking control of your money by spending it wisely.

If you need assistance in preparing an income statement or a balance sheet, please call our office for an appointment.



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QUESTION: I am thinking of going into business with a long-time friend. Although I don't anticipate any serious disagreements, is there some sort of protection we can build into the business in case a dispute arises?

ANSWER: Consider a carefully prepared buy-sell agreement. Typically, these agreements provide that any party to the agreement can offer to buy out the other party or parties to the agreement. The catch is that the other parties can accept the offer or, at their option, buy out the individual for the same price. This type of arrangement ensures that buy-out offers are fairly priced. As an option, the buy-sell price could be determined by a pre-established formula.

QUESTION: A business associate and I are about to incorporate a business. As I understand it, my ownership will be in the form of corporate stock. If this business venture is unsuccessful, will my annual loss from the stock be limited to \$3,000 per year like other stock losses?

ANSWER: As you stated, ordinarily, a loss on a sale or exchange of stock is a capital loss. If, after being combined with other capital gains and losses for the year, the result is a loss, the loss

is then limited to \$3,000 (\$1,500 for married taxpayers filing separately) for the year. Any remaining loss carries over to future years. However, if your stock qualifies as IRC Section 1244 stock, you will be entitled to an ordinary loss of up to \$50,000 (\$100,000 for joint filers). This ordinary loss is fully deductible on your return in the year of the loss. Any loss in excess of \$50,000 (or \$100,000) would be included as capital loss subject to the \$3,000 annual loss limitation and capital loss carryover provisions.

Generally, to qualify as Sec 1244 stock, at the time the stock was issued, the aggregate amount that was received by the corporation for stock, as contributions to capital and as paid-in surplus, must not have exceeded \$1 million. Additionally, the stock must have been issued to you as the original owner, you continuously owned the stock, the stock was not issued as compensation for services and the corporation did not receive more than 50% of its income from passive sources in the prior five years before the loss.

If the business is successful, and you sell your stock for a profit, the entire gain receives capital gain treatment.

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Tax Calendar

September - December 2005

September 15, 2005:

– Third installment of 2005 Individual Estimated Taxes due.

October 17, 2005:

– Last date to timely file your 2004 Individual Tax Return (Form 1040) if you are in the United States and filed an extension with Form 2688.

September – December 2005:

– Time for 2005 Year-End and 2006 Tax Planning. Contact this office to schedule a consultation appointment.

– Taxpayers who began their Minimum IRA Distributions before 2005 must withdraw their 2005 Distribution by December 31.