



# OPERATING A BUSINESS

TAX CONSIDERATIONS

**CAE CPA**  
ACCOUNTING • TAXES

## 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. 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 proprietorship must file Form 1040 Schedule C.
  - Corporations file Form 1120 or 1120S and make estimated tax payments with Forms 1120-W and 8109.
  - Partnerships 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 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 in which 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.

■ **Planning Tip.** The Obama administration has proposed to prohibit taxpayers from using the last-in, first-out (LIFO) method of accounting. Under the proposal, taxpayers would track the cost of goods sold using the costs of the earliest acquired or manufactured inventory items. Businesses would recognize income stemming from any built-up LIFO reserves on a pro-rata basis over the course of eight tax years, beginning with the first tax year after December 31, 2011. The Obama administration has also proposed to repeal the lower-of-cost-or-market adjustments to inventory allowed for taxpayers that do not use the LIFO method of accounting. The proposal would prohibit taxpayers from writing down the taxable value of inventories to reflect a drop in market price, damage, imperfection, or other similar causes.

### **Small business exception**

The IRS prefers the accrual method and until recently many small businesses were forced to switch from the cash method to the accrual method. 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.

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 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.

## 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 statute, regulation and case law are the subject of a special procedure in which the IRS' consent to the change is automatically given.

**Comment.** Rev. Proc. 2008-52 and Rev. Proc. 2009-39 describe the procedures taxpayers may use to obtain automatic consent for a change in method of accounting for more than 30 areas.

## 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.

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.

## *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 whether deferring it until the next year will help minimize taxes.

Under Code Section 179, small businesses can “write-off” (expense) rather than depreciate property placed in service. The *American Recovery and Reinvestment Act of 2009 (2009 Recovery Act)* increased for the 2009 tax year only the maximum Section 179 expensing limit to \$250,000. The *2009 Recovery Act* also increased the maximum investment ceiling to \$800,000, for 2009 only as well.

Congress has not extended Code Sec. 179 expensing for 2010, along with many other popular but temporary tax incentives that expired at the end of 2009. However, Congress can make Code Sec. 179 expensing retroactive to January 1, 2010 if it chooses to extend this incentive through legislation this year.

### **Business expenses**

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

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.

- **Planning Tip.** Taxpayers and the IRS often disagree if an expense can be immediately deducted or must be capitalized. The deduct-or-capitalize question does not just involve what was purchased but also whether its benefits will be expected to last for more than one year. If two taxpayers use an identical item in different ways in their businesses, the item may represent a capital expenditure to one taxpayer but a currently deductible expense to the other taxpayer.

### 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.

**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 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.** Congress has used temporary bonus depreciation several times to encourage business investment and stimulate the economy. For the 2009 tax year, the *2009 Recovery Act* provided qualifying taxpayers with an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualifying property. The property had to be acquired before January 1, 2010 and placed in service during 2009.

- **Planning Tip.** There are special rules for certain types of property, such as transportation property.

The additional first-year bonus depreciation deduction expired December 31, 2009 and Congress has not extended it through 2010. However, the enhanced bonus depreciation deduction is a popu-

lar business tax incentive, and Congress can make the deduction retroactive to January 1, 2010 if it chooses to extend the incentive through this year.

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

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.

## 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.

### 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 normally can be carried back two years. Some NOLs, irrespective of year, can be carried back three years. They include:

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

The *2009 Worker, Homeownership and Business Assistance Act* has extended and enhanced into 2010 a special extended five-year NOL carryback period for almost all businesses (see below for more details).

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.

**Enhanced five-year carryback.** The *2009 Recovery Act* allowed eligible small business taxpayers to carryback 2008 NOLs for three, four or five years. For fiscal year taxpayers, this applies to the NOL arising for the tax year either beginning or ending in 2008 (FY 2008 or FY 2009). Under the *2009 Recovery Act*, this applies

to eligible small businesses with an average of less than \$15 million in gross receipts over a three-year period ending with the year giving rise to the loss.

Under the *2009 Worker, Homeownership and Business Assistance Act*, however, nearly *all* businesses, not just small businesses, can take advantage of the expanded NOL carryback treatment for either 2008 or 2009 NOLs. The new, expanded election is available for NOLs incurred in either 2008 or 2009, but not for both years.

However, an eligible small business that elected under the *2009 Recovery Act* to carryback 2008 NOLs may make the election for an additional year, thus enabling the qualified small business to carry back NOLs from both 2008 and 2009 for up to five years.

**Caution.** Under the *2009 Worker, Homeownership and Business Assistance Act*, an NOL carried back to the fifth year before the loss year is limited to 50 percent of the



available taxable income for that year. Any remaining NOL can fully offset taxable income in the remaining four carryback years.

***Election and timing.*** The election to take advantage of the extended and enhanced NOL carryback provision must be made by the due date (including extensions) for the tax return filed for the taxpayer's last taxable year beginning in 2009. Once made, the election is irrevocable. If the taxpayer previously elected not to carry back an NOL from a tax year ending before November 6, 2009 (the date of the law's enactment), the taxpayer can revoke the election before the due date (including extensions) for filing the taxpayer's 2009 return.

### ***Under the 2009 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 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;
- Disabled access credit;
- Renewable electricity production credit;
- Empowerment zone employment credit;
- Indian employment credit.
- New Markets Credit;

Businesses can also benefit from a number of energy tax incentives. The *Emergency Economic Stabilization Act of*

2008 and the 2009 Recovery Act extend and enhance many energy tax incentives. Some of them are:

- Extended renewable energy production credit;
- Election of investment credit in lieu of production credit;
- New clean renewable energy bonds.

## 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.

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. 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, 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 (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.