1995

1995 tax planning strategies for the small business owners: A Speech for CPAs to deliver to small business owners

American Institute of Certified Public Accountants. Communications Division

1995 TAX-PLANNING STRATEGIES

FOR THE SMALL BUSINESS OWNER

A Speech for CPAs to Deliver to Small Business Owners

Prepared By:

The Communications Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Good Afternoon/Morning. Much of this country's wealth rests with its millions of small businesses. But unfortunately, many small business owners are not able to participate in that wealth because the more successful they become, the more taxes they pay to Uncle Sam.

To minimize this tax bite and contribute to the continued success of your business, it's crucial that you develop a comprehensive tax plan. Today, I'll present a number of tax-planning strategies to help you get started.

For most of you, income and employment taxes constitute the largest portion of your total tax bill. That's why my discussion will focus on these two areas. Although my presentation is tailored to address a general business audience, I'll be happy to answer your specific questions when I'm through. [*OPTIONAL*: The points I'll be making today are very technical, but don't worry about taking notes. After my talk, I'll hand out a brochure* that summarizes my remarks.]

*To order the 1995 tax-planning brochure, *Tax-Saving Solutions for 1995: A CPA's Guide for Small Businesses*, which highlights the points made in this speech, call the AICPA Order Department at 1-800-862-4272 and request product #889535. The cost is $24/100. Another brochure that relates to this topic is, *Business Entities: Understanding Different Forms of Organization for Your Business*, product #889532. The cost $24/100.

Before we begin discussing specific ways to reduce taxes, let's take a moment to review some of the basic tax rules that affect businesses and their owners.

As most of you are aware, the tax rates for corporations and individuals are different. Corporate rates begin at 15 percent for the first $50,000 of taxable income. As income rises above $75,000, the marginal rate quickly reaches 34 percent. And, a maximum rate of 35 percent applies when taxable income reaches $10 million. For individual taxpayers, the tax rate also begins at 15 percent, but may rise as high as 39.6 percent.

This means that, depending upon the income level, the amount of tax actually owed will vary dramatically depending on whether business income is taxed at the individual or corporate rate.

Therefore, the first step in developing a tax-planning strategy is to determine whether you've chosen the most appropriate organizational form for your business. Your choices are: a sole proprietorship, a partnership, a corporation, or a hybrid known as a limited liability company, or LLC. In most cases, corporate shareholders and owners of LLCs do not face personal liability for the debts and obligations of the business. For that reason, most business owners choose to incorporate or operate as an LLC.

Once you choose to incorporate, the key question becomes: Are you better off operating as a C or an S corporation, or as an LLC? Unfortunately, the answer isn't simple.

Under tax law, C corporations and their owners are taxed as separate taxable entities. This means that, as C corporation income is earned, it is taxed once at the corporate level. These earnings are taxed a second time at the individual level when earnings are distributed to shareholders as dividends, or upon liquidation when the assets of the company are sold. For this reason, income from a C corporation is said to be subject to a "double" tax.

S corporations, on the other hand, generally are not subject to any corporate income tax. Instead, S corporation income is taxed at the shareholder's individual rate, regardless of whether or not that income is actually distributed to the owner. Furthermore, S corporation distributions usually aren't taxable to the shareholder. Therefore, the principal tax benefit of S corporations is that income is taxed only once. In addition, S corporation shareholders may be able to deduct corporate losses on their personal returns.

Depending on the actual circumstances of its formation, an LLC can be treated as either a partnership or a corporation for tax purposes. This means that income earned by an LLC will be taxed to the owners at their individual rates if the LLC is treated as a partnership.

A simple example will demonstrate how significant the tax differences are between C corporations, and LLCs treated as partnerships or S corporations. Suppose your individual tax rate is 28 percent and you own a C corporation with $100,000 in taxable income. If all the company's after-tax profits are distributed to you as dividends, you would receive roughly $56,000 after corporate and individual taxes are paid. However, if your business is an S corporation, or an LLC that is treated as a partnership, you would end up with about $72,000 after taxes -- saving almost $16,000 in taxes.

Choosing a subchapter S format, or an LLC treated as a partnership format, has other advantages. Since S corporation shareholders and owners of LLCs treated as partnerships pay tax as income is earned, they increase their tax basis each year. If the business is sold, the taxable gain on the sale could be significantly lower. Also, keep in mind that owners of LLCs that are treated as partnerships and S corporation shareholders may be entitled to deduct business losses on their personal income tax returns.

In addition, S corporation shareholder distributions are not subject to employment taxes. As a result, if you are employed by your S corporation and you pay yourself a reasonable salary, you can withdraw excess earnings from the company free of employment and income taxes. This benefit alone can save you as much as 15.3 cents on every dollar you receive in shareholder distributions.

Now, let me give you a few reasons why you might be better off as a C corporation. In many cases, the individual tax rate actually exceeds the corporate rate at certain levels of income. This means that even though S corporations and LLCs taxed as partnerships are not subject to the "double tax," some S corporation shareholders and owners of LLCs treated as partnerships actually pay more tax on business income than they would under C corporation rules.

Second, let's consider the treatment of company-paid health insurance premiums for you and your family members. Under tax law, C corporations, S corporations, and LLCs treated as partnerships may deduct health-insurance premiums paid for their employees. However, S corporation shareholders must include these amounts in their taxable income as wages, while owners of LLCs treated as partnerships must include these amounts as guaranteed payments. This is a major disadvantage to LLCs treated as partnerships and S corporations. In fact, due to the rising cost of health insurance, some business owners choose to operate as a C corporation just to avoid paying personal income tax on company-paid health insurance.

Another advantage to operating as a C corporation was created when Congress revised the tax code in 1993. At that time, Congress added a provision that allowed some C corporation shareholders in "qualified small businesses" to exclude for tax purposes up to one-half of their gain on the sale of their corporate stock. To qualify, the C corporation stock must have been issued after August 10, 1993, and the stockholder must have owned the stock for at least five years.

[*OPTIONAL*: Keep in mind that Congress currently is debating a capital gains provision in its *Contract With America.*** If passed, it would repeal the qualified small business rule I just mentioned because the *Contract With America*'s 50-percent reduction provides more favorable capital gains treatment for investments.]

There are no hard and fast rules as to which organizational form is best. Your individual circumstances will dictate whether you should choose an S or a C corporation format, or an LLC treated as a partnership format. That's why I strongly recommend that you sit down with your CPA in the

**Current as of July 1, 1995. Keep tuned to the latest events in Washington and delete or modify this paragraph as needed.

near future and revisit this question.

Now, I want to discuss Personal Service Corporations, or PSCs, because these types of businesses present very unique tax issues. PSCs are employee-owned-and-operated corporations providing services in fields such as health, engineering, architecture, accounting, and consulting. PSCs pay a "flat" 35-percent tax regardless of the level of income.

If your business is a PSC, you can avoid the flat rate by electing S corporation status. Or, if your PSC does not make an S election, you still can reduce income taxes by paying company earnings to yourself as salary, as long as your personal marginal rate is below 35 percent. Although these salary payments will be subject to employment taxes, you may be able to reduce your overall tax bite this way.

Regardless of what type of organizational form you choose, one of the best ways to reduce taxes is to claim every tax deduction for which your business is entitled.

First, let's discuss the tax deductions available to your business for contributions made to a qualified retirement plan.

If you maintain a "qualified" plan, your company may be able to immediately deduct the contributions made to the plan. Furthermore, you and other employees won't be taxed until retirement benefits are paid. In addition, any earnings in the retirement plan will accumulate tax-free until withdrawal.

If your retirement plan doesn't fall within the "qualified" plan rules, there are still some valuable tax benefits. Contributions made by a business to a "non-qualified" plan still are deductible. However, your company cannot take these deductions until the benefits are available to employees free of forfeiture.

Now I'll talk about reducing your tax bill by setting your own compensation at the optional level. C corporation owners can maximize their company's deductions for compensation payments if they increase the amount they pay themselves and their family members for services provided to the company. Owners of C corporations can reduce their tax bill even more, if their individual tax rate is lower than the corporate rate.

However, you must be certain that the salary you pay yourself and your family members is reasonable. If the IRS believes you or your family members are taking excessive compensation, it may re-characterize these salary payments as dividends. This can be devastating since dividends are non-deductible to C corporations, but are fully taxable to you. Of course, the payment of additional employment taxes also must be considered whenever corporate earnings are paid out as additional salary.

Now, if your business operates as an S corporation, you also can reduce taxes by setting your compensation at the appropriate level. As an S corporation, you, as a shareholder, will pay income tax on the S corporation's income regardless of whether you actually withdraw the income. Once S corporation income is taxed, you won't pay income tax a second time when the income is withdrawn as either salary or as a shareholder distribution.

However, since shareholder distributions from an S corporation's income are not subject to employment taxes, you can decrease taxes by reducing your salary level and increasing your S corporation distribution. The IRS is aware of this technique, so it will carefully scrutinize your salary level to make sure that you're paying yourself <u>enough</u> salary for the services you are performing.

Another way to reduce your corporate taxes is by electing to treat the cost of newly acquired depreciable property as an immediate expense.

This is how it works. Rather than depreciating new property over a certain number of years, you may choose to immediately deduct up to $17,500 of the cost of certain types of property you acquire in the year you place it in service. Office equipment and machinery are two types of property that qualify for the "immediate expense deduction." However, the deduction "phases out" once the cost of qualifying property exceeds $200,000. To get the most from the immediate expense deduction, be sure to claim it for whatever property you acquire during the year that has the longest cost-recovery period.

[*OPTIONAL*: In addition to the capital gains clause I mentioned before, the *Contract With America****** also has a provision on depreciation reform. If passed, it would raise the amount of property available for the immediate expense deduction.]

Also, don't forget to reduce your tax bill by taking deductions for the health insurance premiums you pay for your employees and for amounts you pay to reimburse employees for medical expenses. As long as these employees are not S corporation shareholders, the employees do not have to include these amounts in their taxable income.

Now, let's take a look at employment taxes. An employer is required to withhold Social Security taxes from wages paid an employee and match the tax withheld. For 1995, the combined Social Security tax rate is 7.65 percent, which consists of a 6.2-percent component for old age, survivor, and disability insurance, on wages up to $61,200, and a 1.45-percent component for Medicare on all wages. Thus, if you work for your business, up to 15.3 percent of your salary may have to be paid in Social

***Current as of July 1, 1995. Keep tuned to the latest events in Washington and delete or modify this paragraph as needed.

Security taxes. However, as an employer, you may deduct the Social Security tax as a deductible business expense.

Another way to reduce employment taxes, and maybe even income taxes, is to lease your own assets to your company. For example, suppose you own the building where your company operates, or you own the equipment your company uses. Your company could lease the building or the equipment from you, and the business could deduct the rental payments. While you would have to pay personal income tax on the rent you receive from your company, you wouldn't have to pay employment taxes since rent isn't considered earned income. In addition, if your business is a C corporation, the so-called "double tax" is reduced since the company can deduct the rental payments.

The last topic I want to cover today is choosing an accounting method. The two most common are the accrual method and the cash method.

Under the accrual method of accounting, you must recognize income when all events that determine the right to receive income have occurred (that is, when you provide goods and services to your customers). Likewise, as an accrual basis taxpayer, you generally aren't entitled to tax deductions for expenses until all events have occurred that fix the amount and determine your liability to pay. Thus, if you use the accrual method, you usually can't prepay expenses or defer income for tax-saving purposes.

Under the cash method of accounting, however, you are not required to recognize income until you actually or constructively receive payment. Likewise, you generally can deduct expenses as they are paid. Consequently, in some cases, you can prepay your deductible expenses at the end of the year and defer income until later tax years to help you reduce your taxes.

Therefore, if you are currently operating under the accrual method, you may want to consider switching to the cash method. In addition, regardless of whether you are a C or S corporation, you must use the accrual method if you derive a substantial amount of income from sales of inventory items.

By now you have probably come to the conclusion that tax rules for small businesses are complicated. You're right, and it seems they are getting more so every year.

However, there is some potential good news on the horizon for small businesses whose calendar year ends in the middle of their busiest season. [Part of the current tax debate in Washington is a bill**** introduced with the assistance of the American Institute of Certified Public Accountants (AICPA) that would lead to fairer tax treatment of small businesses by allowing them to chose the fiscal year that best suits their business cycle. In addition, it would relieve the compressed workload forced on CPAs by enactment of the Tax Reform Act of 1986.]

I hope I've given you some worthwhile tax-saving tips that will help you utilize the tax law to your advantage. However, in most cases, it's not in your best interest to go it alone. The advice of a tax professional is essential to guide you through the maze of tax issues that arise both in forming and in operating your business. Because CPAs provide tax advice

****Current as of July 1, 1995. Keep tuned to the latest events in Washington and delete or modify this paragraph as needed.

to a variety of businesses, I recommend that you look to a CPA to provide you with the expertise you need.

Now I'll be happy to answer any questions.

Speeches Available From the AICPA

Financial Recordkeeping: Organizing Your Past to Plan Your Future (1995)

No. 889473...$5.50

A Gift for Those Who Give: A Guide to Deducting Charitable Contributions (1995)

No. 889476...$5.50

Corporation: To Be or Not to Be? Choice of Entity Issues for Small Business (1995)

No. 890683...$5.50

Financial Planning for Your Business (1994)

No. 890678...$5.50

Succession Planning for Small Business Owners (1994)

No. 890677...$5.50

Business Loans: How to Get the Financing You Need (1994)

No. 890679...$5.50

Planning and Saving for Your Child's College Years (1995)

No. 890825...$5.50

Achieving Financial Security for Your Retirement Years (1993)

No. 890630...$5.50

Estate Planning Tips for Individuals (1995)

No. 890688...$5.50

Tips for Cutting and Containing the Costs of Owning a Home (1992)

No. 890663...$5.50

What You Should Know About Your Future Social Security Benefits (1995)

No. 890687...$5.50

Dealing With a Financial Downturn (1991)

No. 890562...$5.50

Control Your Credit Before It Controls You (1991)

No. 890561...$5.50

The Journey to Financial Independence (1990)

No. 889474...$5.50

Shaping Up Your Future With Personal Financial Planning (1995)

No. 890644...$5.50

EVALUATION FORM

To help us better meet your needs for speeches and other publications, please fill out this form and return it to:

Carmela Chinnici
Communications Division
American Institute of CPAs
1211 Avenue of the Americas
New York, New York 10036-8775

1. Title of Speech ____________________

2. Please indicate how you use this speech:

   ___ Presented verbatim
   ___ Presented with modification
   ___ Used as a basis for writing other speeches or articles

3. To whom did you present this speech?

   ___ Client
   ___ Civic or community group
   ___ Nonprofit or charitable organization
   ___ Other *(please specify)* ____________________

4. Please rate the quality of the speech:

   ___ Excellent
   ___ Good
   ___ Fair
   ___ Poor

5. On what additional topics would you like us to prepare speeches?

   ____

   ____

6. Please provide us with any suggestions you may have on how we can improve this speech:

   ____

   ____

(OPTIONAL) Name & Phone #: ____________________