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Making the Most of the New Tax Law: Tax Planning for the Small Business Owner

A Speech for CPAs to Deliver to General Audiences

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Regardless of the size of your business or how it is structured, all business owners share one common partner: Uncle Sam. Whether you are planning to purchase new equipment, hire new employees, or implement or change a retirement plan, Uncle Sam will have something to say about it. Indeed, virtually every business transaction has some tax consequence.

The best way to deal with Uncle Sam is to arm yourself with knowledge. Stated simply, if you understand basic tax issues, you can avoid some basic tax problems. That's why I'm here today. To help you acquire the knowledge you need to effectively address tax issues, including those resulting from the most recent changes in the tax law. Whether you're a retailer, professional, craftsperson, small manufacturer or owner of any small business, staying up to date on the tax law can help you minimize your tax bill and ward off potential problems with the IRS down the road.

Before I get into the nitty-gritty of taxes, I want to emphasize that the best way to look at Uncle Sam is as a partner who presents you with opportunities ▓ in particular, opportunities for tax savings that can help boost your profits. The reason I say this is that I've seen too many small businesses let their concern about tax issues and fear of dealing with the IRS result in an ineffective or defensive tax strategy. By examining the tax law in light of both your responsibilities and the opportunities for tax savings, I hope to help you develop an offensive tax strategy that benefits both you and your business.

My focus is on tax planning and I emphasize planning, because planning is what ultimately leads to action. As I discuss factors to consider in planning and implementing a tax strategy for your business, I'll be commenting on some of the significant aspects of the new tax law. You can limit your note taking because at the end of the presentation I will be

distributing a brochure that highlights key aspects of the tax law.

Under the laws of most states, you can establish your business as a corporation, partnership, limited liability company, or sole proprietorship. I'll briefly review the aspects of each of these and discuss how the new tax law impacts them.

The C corporation is the most standard form of corporation. You and your C corporation are separate legal entities in the eyes of the IRS and are therefore taxed separately. The corporation pays its own taxes at rates which range from 15 to 39 percent, while an individual's tax rate ranges from 15 to 39.6 percent. A corporation can have virtually any number of shareholders. However, given that the focus of this presentation is on small businesses, I'll assume that all of the corporate stock is owned by one person or a few people and that shareholders are actively involved in the management of the business.

As a shareholder in a C corporation, you personally don't pay tax on money earned by the corporation until you receive payments as compensation for services or as dividends. Although a corporation can deduct compensation payments, it cannot deduct dividend payments. As a result, the corporation and its shareholders pay taxes on the same income, when dividend payments are made by a C corporation.

If you're planning to transfer a significant portion of appreciated company stock that has appreciated to an individual outside the company, there's a bit of bad news. The new tax law has tightened the rules requiring gain recognition on certain distributions of controlled corporation stock.

Under the prior law, in situations where appreciated property was distributed to shareholders, neither the distributing company nor the shareholders were taxed on the distribution. However, the new tax law requires that gain be recognized by the distributing company, as of the date of the distribution, if one or more persons who are not the distributee shareholders acquire 50 percent or more of your corporate stock. Although there are some exceptions, these changes are generally effective for distributions after April 16, 1997. In effect, this means that if you choose to convey a substantial portion of the business to someone else by transferring stock, you can expect to pay a capital gains tax.

In addition to this change, the tax law also resulted in modifications to rules requiring gain recognition for certain extraordinary dividends and to rules governing the tax treatment of certain corporate stock transfers. These and some of the other changes affecting specific types of corporations are too complex to review during today's presentation, but I'd be happy to discuss them with you

afterward if you expect to make or be the recipient of such transfers.

For now, I'd like to comment on some basic tax strategies. Regardless of how your business is organized, one of the main tax strategies to keep in mind is to manage the timing of the recognition of income to lower taxes.

Deferring income, to the extent possible under the tax law, typically makes smart tax sense. However, if you expect your business to be in a substantially higher tax bracket next year because you expect higher revenues -- possibly due to the introduction of new products or for other reasons -- you may want to move income into the current tax year.

Another key strategy is to use net operating losses and other business losses to your advantage. A net operating loss is generated when your business's deductions for the year are more than its income. Net operating losses from one year can be matched against income of other years, subject to certain restrictions. By timing when you claim such losses, you can substantially reduce your business's tax burden.

A net operating loss for 1997 may be carried back against income of the prior three years, 1994 through 1996. However, beginning in 1998, the new tax law reduces the carryback period of a net operating loss from three years to two years and increases the carryover period from 15 to 20 years, with a few exceptions. Thus, corporations face greater restrictions on the use of business operating losses.

The new law also imposes limits on the tax benefits a corporation can realize from life insurance on persons involved in its business. Under the existing law, beneficiary businesses cannot deduct the premiums paid on insurance contracts that cover the lives of an officer, employee, or other person financially interested in the business.

The law expands these limitations by providing that no deduction is permitted for premiums paid on any life insurance contract, annuity contract, or endowment contracts if the taxpayer is directly or indirectly a beneficiary under the contract. Also, generally, no deduction is allowed for interest paid or accrued on any indebtedness with respect to a life insurance policy, endowment, or annuity contract covering the life of any individual.

Another tax law change is actually good news for the smaller corporation. Smaller corporations, defined as those which had average annual gross receipts of $5 million or less for its 1995, 96, and 97 tax years, will no longer be subject to the corporate alternative tax -- the AMT -- of 20 percent.

Finally, -- and this is a small change but one that gets back to what I said earlier about looking to Uncle Sam for opportunities -- for tax years beginning after 1997 and before 2000, the rules allowing a corporate charitable

deduction for the full fair market value of certain inventory given to charity now includes gifts of certain computer technology and equipment that is used in the U.S. for educational purposes in grades kindergarten through 12. If you're looking for a relatively easy way to reduce your taxable income while benefiting others, this new rule gives you an excellent opportunity to make a meaningful tax-deductible contribution.

Keep in mind that regulator or C corporations can deduct qualified charitable contributions of up to 10 percent of modified taxable income each year. The unused portion may be carried forward five years.

I'd like to switch gears now to other business forms, such as the S corporation, partnership, limited liability company or LLC, and the most common of all -- sole proprietor. Generally, these types of entities are less complex than a corporation. Keep in mind that the tax rules governing them are significantly different than those governing a C corporation.

For starters, in an S corporation, profits and losses pass through the corporation to its shareholders, with no extra tax to the corporation. Each shareholder includes his or her proportionate share of profits and losses in his or her individual income, where it is taxed at personal income tax rates. That means as a business owner you're not paying double taxes as you are with a regular C corp.

Here's another tax advantage. Because, with limited exceptions, corporate long-term capital gains are taxed directly to shareholders, shareholders can offset gains with capital losses on their personal returns. Similarly, corporate net operating losses of an S corporation are deductible directly by shareholders, subject to limitations, and therefore, reduce overall taxable income.

Partnerships, like S corporations, function as a conduit through which the various tax attributes flow to the partners. Partners' taxes are impacted by their share of partnership income, gains, losses, deductions, or credits as reported on Schedule K. While the partnership is not a taxable entity, you must report partnership income and losses on Form 1065. Partners may also be liable for self-employment tax. This tax can take a big bite out of your profits.

Here's something else to keep in mind: losses from partnership operations recognized by each partner are limited to the adjusted basis in his or her partnership interest. The adjusted basis is the total contributions of the partner

- Increased or decreased by his or her allocated share of profits and losses from operations in prior years;
- Increased by his or her share of certain partnership liabilities; and

- Reduced by withdrawals.

If the loss is in excess of the allowable limit for any one year, it may be carried forward to be used in a year in which the partner's basis exceeds losses.

The new tax law changed some of the rules affecting partnerships, some of which I'd like to make you aware of now.

1. First, it modified the basis allocation rules for distributee partners, so that the basis of distributed property is allocated generally in proportion to the fair market values of the property. This applies to partnership distributions of property (other than money) made after August 5, 1997.
2. Also, the law eliminates the requirement that inventory be substantially appreciated to give rise to ordinary income treatment with respect to sales or exchanges of partnership interest after August 5, 1997.
3. Another major change modifies the exception to the general rule that a partner is able to contribute appreciated property to a partnership without recognizing gain.

Under the prior law, if the property was subsequently distributed to another partner within five years of the date of contribution, the contributing partner generally recognized gain as if the property had been sold for its fair market value at the date of the distribution. The law extends that five-year period to seven years. The provision is effective for property contributed to a partnership after June 8, 1997. An exception is provided for property contributed to a partnership pusuant to a written binding contract in effect on June 8, 1997.

There are other complex tax rules that also impact the tax treatment of distributions to partners. Before making any significant distributions, it's wise to check with your tax advisor to determine the tax impact on the partnership and your personal income tax.

There is a major feature of partnerships which has made some professionals wary of this organizational form. The issue is that, in a partnership, all partners are held personally liable for the debts of the company, as well as any individual wrongdoing, even if they were not directly involved in it. On the other hand, as the owner of either a C corporation or S corporation, you are not liable for the company's debts.

The liability issue has given rise to a relatively new form of business -- limited liability companies. These combine the liability protection of a corporation with the tax advantages of a partnership. As with corporations, owners of LLCs are not generally liable for debts and obligations of the LLC.

What's more, individual owners are taxed like partners; that is, at their own individual rates. They are also, however, responsible for paying self-employment taxes.

As a sole proprietor, your business's net profit or loss is combined with your other income, which is then taxed at your individual rate. You are also responsible for paying self-employment tax. The most serious disadvantage of conducting business as a sole proprietorship is the unlimited liability you face. If you are a sole practitioner and don't feel that the liability issue is a major concern for you right now, you can continue to operate as a sole proprietor. But keep in mind that as your business develops, you may want to switch to another organizational form.

For the remaining time, I want to highlight some of the tax deductions available to business owners. We've touched on a few of them, but there are a host of others you need to be aware of, including new tax breaks resulting from the 1997 Taxpayer Relief Act.

Let's begin with charitable contributions, which I mentioned earlier. The deduction for charitable contributions made by C corporations is limited to 10 percent of modified taxable income. However, as a sole proprietor, shareholder or partner, you can make cash gifts to charity of up to 50 percent of your adjusted gross income and appreciated property up to 30 percent of AGI. What's more, when you donate appreciated property, you not only get a deduction but you also escape taxes on any capital gains. Another way to be charitable and earn you a tax deduction is to donate excess inventory.

In addition to considering charitable contributions, each tax year you should determine a strategy for the purchase and depreciation of property to be used in the business. Depreciation deductions can be claimed on property purchased for business use. Essentially, the law permits a deduction of a reasonable allowance for the exhaustion, wear, and tear of property used in the business. The amount of the deduction varies based on which cost recovery system is used. Consider the types of property you have purchased this year and map out a strategy for purchasing other equipment to make the most of the depreciation deduction.

Next, identify equipment that you can expense. An alternative to depreciating property is claiming an expensing deduction on your tax return. Generally, businesses can elect to deduct up to $18,000 of the cost of qualifying property placed in service by the end of the 1997 year and $18,500 for the 1998 tax year.

If you have some purchases that you've postponed, consider whether making them before year-end or in 1998 will entitle you to a bigger deduction. However, be aware that the deduction is reduced dollar for dollar to the extent that total equipment purchases exceed $200,000 for the year.

You should also take the time to identify bad debts. Uncle Sam will allow accrual basis taxpayers a deduction for bad business debts in the year they become partially or totally worthless.

You will also want to consider whether you can deduct losses attributed to obsolete inventory. Goods that cannot be sold at normal prices or in the usual way may be valued at bona fide selling prices, less the direct costs of disposition. Take the time now to review your inventory and the rules affecting the deduction for obsolete inventory so you can claim qualified losses.

Depending on your form of business, many fringe benefits also offer tax deductions. Corporations can typically deduct health insurance costs paid on behalf of their employees or shareholders. The cost of partners' health insurance benefits are generally not deductible by the partnership. However, if you are self-employed or a principal in a partnership, you may deduct 40 percent of your medical insurance premiums for yourself, your spouse and your children in 1997. In 1998, the deduction will increase to 45 percent and, as a result of the new tax law, will be 100 percent deductible by 2007.

Funding qualified pension and profit-sharing plans also entitles you to business deductions, within limits, and is a tax-smart way for rewarding and compensating employees. Contributions for employees are fully tax-deductible. In order to claim a deduction, your plan must be in existence by December 31, so if you haven't set up a plan yet, you may want to do so now.

A new type of pension plan available to employers with 100 or fewer employees is a SIMPLE plan which stands for Savings Incentive Match Plan for Employees. Under a SIMPLE plan, qualified employees can set aside $6,000 a year tax-deferred while employers match their contributions, limited to 15 percent of aggregate compensation. You can take advantage of a SIMPLE plan if you're a sole proprietor or if you have a partnership, subchapter S corporation, incorporated business, or limited liability corporation.

Employees with at least $5,000 of income in any two preceding years are eligible to participate in SIMPLE plans as long as their expected income for the current year also is $5,000 or more.

If the company offers a 401(k) plan, employers can generally deposit 15 percent of an employee's salary each year, up to a maximum of $9,500 in 1997. This number may be adjusted for 1998.

Of course, if you are self-employed, you have the option of establishing Keoghs or SEPs Simplified Employee Pensions. Generally, you can deduct up to 25 percent of your net self employment income or $30,000, whichever is less.

If your business routinely reimburses employees for travel, meal and entertainment costs, make sure you meet the accountable reimbursement plan rules to make sure such reimbursements will be deductible by your business. Typically, business travel expenses that are necessary and ordinary to your business or industry are fully deductible. Business-related meals and entertainment are 50-percent deductible. What's more, as a result of the new tax law, employers may deduct the full cost of providing meals to employees if the meals are provided for the convenience of the employer and served on the business's premises. Keep in mind that the tax law mandates that employees submit adequate supporting documentation.

In addition to these many tax deductions that reduce a business's income, business owners need to be aware of tax credits that can directly reduce a business's tax liability.

To encourage continuing investment by businesses in research activities, the research tax credit, which had expired and generally did not apply to amounts paid or incurred after May 31, 1997, is extended for 13 months generally for the period June 1, 1997 through June 30, 1998. If you've postponed conducting such research, consider how the credit will affect your 1997 and 1998 tax liability, and whether it will free up the cash you need for research projects.

The new tax law also extends the work opportunity tax credit to employees who begin work after September 30, 1997 (when the credit was due to expire) through June 30, 1998. Qualified workers include high-risk youths, vocational rehabilitation referrals, certain veterans and ex-felons, as well as recipients of Supplemental Social Security Income. The credit is equal to 25 percent of wages for employment of up to 400 hours, and 40 percent for employment of 400 or more hours.

The Taxpayer Relief Act also provides a new "welfare-to-work" credit to employers for qualified wages paid to long-term family assistance recipients during the first two years of their employment. The credit for the first year of service is 35 percent of the first $10,000 of qualified wages and for the second year is 50 percent of the first $10,000 of qualified wages. You can claim this credit for individuals who begin work for you after 1997 and before May 1, 1999.

The general business credit, which combines a variety of business credits, such as the employer Social Security credit and investment tax credit, has also been modified by the new tax law. The change reduces the carryback period for the general business credit from 3 years to 1 year, while increasing the carryforward period from 15 years to 20 years. The reduction in the carryback period is particularly significant. It means that credits arising in tax years before 1998 can still be carried back three years, but unused credits that arise in 1998 can only be carried back to 1997.

As a result, a taxpayer who paid tax in 1995 and/or 1996 will lose the opportunity to recover those taxes by credit carryback, unless the taxpayer has a large enough unused credit in 1997.

Finally, before I move off the topic of income tax planning and maximizing opportunities in the tax law I want to make a few comments and warnings about the Alternative Minimum Tax (AMT) . You or your company will have to pay AMT if it is higher than your regular tax. The AMT is designed to eliminate excessive benefits that result from using certain deductions, credits, and exclusions to reduce regular tax.

If you are concerned about the AMT, consider these strategies for avoiding it:

- Postpone exercising stock options until next year;
- Use straight-line depreciation instead of accelerated depreciation on new purchases; and
- Lease equipment rather than buy it.

Depending on the nature of your business, there may be other tax-savings opportunities available to you.

I'd like to end my discussion today with a few comments on the changes to the estate tax planning rules affecting family businesses and farms. Family businesses and farms got a big tax break as a result of the new tax law. In the event of an owner's death, they can escape estate taxes on $1.3 million of assets beginning in 1998. (As an aside, the estate tax exemption for individuals was increased from $600,000 to $625,000 for 1998, phasing up to a $1 million exemption in 2006.)

Although businesses and farms must meet some very specific and strict tax rules in order to claim the higher estate tax exemption, understanding the tax rules can help business owners plan for the transfer of their estate in a way that generates the greatest tax break ▒ and is the most beneficial to those who will continue to run the business or farm. Estate planning for family businesses is a topic for another day. However, I wanted you to be alerted not only to estate taxes, but, more importantly, estate planning opportunities. As I said at the beginning of my presentation, an awareness of tax opportunities can help you develop an offensive tax strategy and make the most of your income.

I realize I've covered a tremendous amount in the past 20 minutes and I'm sure there are some questions about the tax law. I'd be happy to take a few moments now to address some of those questions.

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