PacificCPE

COURSE

32701A

Tax Planning for Small Business: Part 1

Starting or winding down a business comes with significant tax implications that can catch small business owners off guard. This course covers the tax treatment of distributions from various business entities, along with practical strategies for both opening and closing a business. Whether you advise clients at the startup stage or are helping them exit, you'll walk away with actionable planning ideas to minimize tax liability and avoid common pitfalls at every stage of the business lifecycle.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

Start Course ↓

Final Exam Copy ↓

LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify beneficial income and deduction strategies.
- Recall the account used by S corporations to keep tabs on undistributed amounts that were taxed to shareholders
- Identify workable strategies when opening or closing a business.

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Income and Deduction Strategies

Chapter Objective

After completing this chapter, you should be able to:

- Identify beneficial income and deduction strategies.

Understanding what income you must report and the various business deductions you may claim is only half the job. You must also know when to report income and when to postpone it, when to claim certain deductions and when not to claim them. You should also be aware of the common traps that business owners often fall into with their income and deductions so you can audit-proof your return to the extent possible.

Tax planning is always complicated, but this is a time of particular confusion. While many of the tax changes made by recent legislation are permanent, many others are temporary. And some rules that have been enacted don't take effect until future years, giving you time to adjust policies and procedures. What's more, new legislation that may come about always contains uncertainties requiring technical corrections in Congress or IRS guidance. And don't ignore tax changes on the state and local levels that may impact you. They're not covered in this course but you need to address them.

Finally, while it's vital that you know about various tax rules, it's also important to recognize that you should not always go at it alone. You may want the assistance of tax professionals or additional information from the IRS to fully understand the conditions for various tax breaks and whether they apply to your business. You need to know how to obtain referrals to tax professionals. If you do go it alone, you should also know how to obtain help from the IRS (discussed in 11).

TAX-SAVING TIPS

Tax-Planning Decisions

Some deductions are under your control because you can decide whether to incur the expenditure. Also, sometimes you are permitted to make tax elections on when to report income or when to claim write-offs. Here are some pointers that can help you minimize your income and maximize your deductions. Or, you can follow the reverse strategy if you already have losses for the year and want to accelerate income to offset those losses (and defer deductions).

- Cash basis businesses. If you account for your expenses and income on a cash basis as most small businesses do, you can influence when you receive income and claim deductions for year-end items. For example, you can delay billing out for services or merchandise so that payment will be received in the following year. In deferring income for services or goods sold, do not delay billing if payment collection may be in jeopardy. Also, consider the impact of payment now versus later on your cash flow needs. And if you are the owner of a pass-through entity, factor in your tax bracket for this year and the bracket you expect to be in next year. If you will be in a higher tax bracket next year because your income will be greater or because of tax law changes, you may not want to defer income. You may prefer to bill and collect as soon as possible to report the income in the lower-tax year.

On the flip side, as a year-end tax planning strategy you can accelerate deductions by paying outstanding bills and stocking up on supplies. Again, determine whether accelerating deductions makes sense for you.

In accelerating deductions, do not prepay expenses that relate to items extending beyond one year. For example, if you pay a 3-year subscription to a trade magazine, you can deduct only the portion of the subscription (one-third) that relates to the current year; the balance is deductible in future years as allocated.

- Accrual method businesses. The board of directors of an accrual-basis C corporation can authorize a charitable contribution and make note of it in the corporate minutes. A current deduction can be claimed even if the contribution is paid after the end of the year, as long as it is paid no later than 2½ months after the close of the year. Similarly, accrual method businesses can accrue bonuses and other payments to employees in the current year that are paid within 2½ months of the close of the year. This rule does not extend to payments to S corporation owner-employees—payments are deductible only when received by the owner-employees.
- Owner participation. If you own a business that’s in a loss position, be sure that your level of participation is sufficient to allow you to deduct all your losses under the passive loss limitation rules and, if profitable, avoid the 3.8% tax on net investment income. Increase your level of participation, and keep records of how and when you participated in the business.
- Increase basis to fully utilize losses. If you are an owner in a pass-through entity, your share of losses generally is deductible only to the extent of your basis in the business. Explore ways in which to increase your basis so that the losses can be fully utilized. For example, if you are an S corporation

shareholder, you can increase basis by lending funds to your business. Alternatively, you can work with the corporation's lenders to restructure debt, making you primarily liable for the amount borrowed.

- Minimize FICA. Owners who work for their corporations may be able to extract distributions on a FICA-free basis by arranging loans or rentals to the business and taking payments in the form of interest or rents. Of course, these arrangements must be bona fide. S corporation shareholders who perform substantial services for their corporation should not erroneously characterize compensation as dividends. And W-2 wages are important for optimizing the qualified business income deduction.
- Review qualified retirement plan selection. If you are self-employed and use an IRA, SEP, SIMPLE, or other qualified plan to save for retirement, review your choice of plan annually to see if it optimizes your benefits while keeping costs down. Factor in tax credits for offering certain retirement plans and the conditions for qualifying for the credits.

Similarly, corporations should review existing plans to see whether terminations or other courses of action are warranted as cost-cutting measures. If you want to terminate one plan and begin another, do not do so without consulting a pension expert. You must be sure that your old plan is in full compliance with the tax laws before it is terminated.

- Carry medical coverage for yourself and employees. Buy the kind of coverage you can afford, and if you're an ALE, be sure it meets minimum essential coverage requirements. Even if you cannot receive this company-provided benefit for yourself on a tax-free basis (if, for example, you are a partner or S corporation shareholder who must include business-paid insurance in your income), you may deduct 100% of the coverage on your individual return.

  You can reduce the cost of coverage to the business by buying a high-deductible plan that allows employees to contribute to health savings accounts (HSAs) on a tax-deductible basis. Alternatively, you can make deductible contributions to an HSA on behalf of your employees. If you are not subject to the employer mandate, you can shift most of the cost of coverage to employees by adopting a premium-only cafeteria plan. Or you may be able to use a type of health reimbursement arrangement to help employees pay for their individually-obtained coverage. You may be able to use other reimbursement options, such as an Excepted Benefit Health Reimbursement Arrangement, to pay for certain costs not covered by insurance.

If you pay at least half the premiums for your employees and qualify as a small employer, you can claim a tax credit for a percentage of your payments.

- Institute other employee benefit plans. If you have a C corporation that is profitable and you are a shareholder-employee, you may be able to turn your nondeductible personal expenses into deductible business expenses. For example, you can have the corporation institute a group term life insurance plan for employees and obtain tax-free coverage up to $50,000. Of course, in weighing the advantages and disadvantages of employee benefit plans, be sure to consider the cost of covering rank-and-file employees, since most benefit plans have strict nondiscrimination rules. Also, take into account the fact that employer-paid educational assistance and adoption assistance plans cannot give more than 5% of benefits to shareholders owning more than 5% of the stock, usually making such plans undesirable for closely held corporations.
- Adopt expense reimbursement arrangements. If your corporation reimburses you for travel, work-from-home expenses (e.g., internet access fees), and other business costs, be sure that the arrangement is treated as an accountable plan. This will ensure that not only does the business save on employment taxes, but also that employees are not taxed on reimbursements. With an accountable plan, the business deducts the expenses, and no income is reported to employees. If your business is incorporated and you are an employee, you can benefit from this arrangement as well.
- Abandon versus selling of property. If you have property that simply is of no value to the business, you may want to abandon it rather than sell it for a nominal amount. This will allow the business to take an ordinary loss deduction rather than a capital loss on a sale. A sale of Section 1231 property may result in a capital or ordinary loss, depending on other Section 1231 transactions for the current year and prior Section 1231 losses.
- Take disaster losses in the prior year. If you suffer a disaster loss to business property in an area declared to be eligible for federal disaster assistance, consider claiming the deduction on an original or amended return for the year preceding the year of the loss if this will give you needed cash flow or result in a greater benefit from the deduction.
- Review the business structure. Changes in the business climate, in business goals, tax laws, and state laws may warrant a change in the form of business organization. For example, your business may start as a sole proprietorship; later you may want to incorporate in order to take advantage of certain

employee benefit plans or to make it easy to bring in investors. Review the options that will afford tax reduction and other benefits.

- Do year-end planning. Businesses have an opportunity to save on taxes with year-end planning. Well-timed expenditures for which tax credits or deductions are available may prove advantageous. Begin year-end planning well before the end of the year in order to have time to implement your decisions.
- Stay abreast of tax law changes. New opportunities are continually being created— through Congressional action, court decisions, and IRS rulings.

Post-Year Tax Elections to Cut Your Tax Bill

Even though the tax year is over, there are still certain decisions that you can make after the year has ended to favorably impact your tax liability. Here are some elections and actions that can be helpful when you file your tax return for the current year:

- Take optimum write-offs for business equipment purchases. When the business can benefit from a larger deduction, instead of depreciating the cost of equipment over the life of the property, consider electing the Section 179 deduction or using bonus depreciation. Alternatively, when the business cannot benefit from a current deduction because it does not have sufficient income to offset it or you may be subject to the limit on excess noncorporate losses, consider other write-off options. Time business equipment purchases carefully in view of the mid-quarter convention.
- Installment sale. Usually, if you sold property on an installment basis where at least one payment is due after the year of sale, you report the gain over the period in which payments are made. But you may opt to report all of the gain in the year of sale, regardless of when payments are received. This is done simply by reporting the full amount of gain on the return for the year of the sale. Reporting the full gain may be advisable if you have losses in the year of sale or loss carryovers to offset the gains. It may also make sense if you expect to be in a higher tax bracket when additional installment payments will be received. Special rules apply to the sale of farmland.
- Real estate professionals. If you own multiple rental properties that produce a net loss, you can escape the passive activity loss limitation imposed on investors by aggregating the properties to qualify as a real estate professional. To do this, you must attach an election to your return. Without the election, a reported net loss may be disallowed. What’s more, unless qualifying as a real estate professional, income from real estate activities