FINANCE 301

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My Knowledge Transfer Plan

Chapter 12: Taxation Basics

As a new business owner, the first decisions you must make involve taxes. In most cases, however, you will feel so elated during your first days of ownership that you'll just abdicate those decisions to your accountant and/or lawyer.

Then, someday in the future, you will read an article, like this one, and wonder to yourself, "Hmm…" You therefore clip the article and send it to your accountant and/or lawyer. They, in turn, give you a long-winded explanation as to why the author of that article is wrong. Or, worse, *they* will write to the author and tell him why he is wrong.

Please, save your breath and your typing fingers. I am not wrong. Here are the taxation basics you need to know.

DECISION ONE: BUSINESS ENTITY

There are several ways businesses can be classified for tax purposes. The first is *sole proprietorship,* which means all income and expenses are recognized on the proprietor's individual tax return. This type of ownership is simple and the least expensive for tax purposes.

It is also the riskiest way to operate a business. As a business owner, you must take care to protect your business and your personal assets. As a sole proprietor, there is no protection.

Sure, you can buy insurance in the event of litigation, but your personal assets remain at risk if the judgment rises above the insurance amount, or if the insurance doesn't pay off. (Note, if fraud occurred, then most insurance companies will not pay the claim.)

If a business involves two or more proprietors, then it is called a *partnership.* For potential risks, please see above – except multiply the consequences by the number of partners.

In addition to protecting/drawing a line between your personal assets and those of your business, you also need to be concerned about how to transfer your business in the event of a proprietor's death, or if one of them wants to sell the business. Every business will be sold someday; the only question is whether the owner/operator remains alive at the time of the sale. The death of a sole proprietor shuts down the business; the death of a partner also shuts down the business.

There are a few similarities between an *S corporation* and a *C corporation,* two more business classifications to consider for tax purposes, if applicable. Under normal circumstances, both protect the owner's personal assets from litigation. Moreover, both offer the same business transferability during his or her lifetime, or at death.

The profit/loss of an S corporation is taxed at the shareholder's tax rate, however; C corporations have their own tax at the entity level. This could lead to a double tax on corporate profits – both today and when they are taken out in the future. (More on that in a bit.)

A *limited liability company* (LLC) is a flexible business entity that can be taxed either as an unincorporated entity or as a corporate entity.

Now, you might be thinking: "Gee, I bought out my parents and just kept things the way they did them."

Well, unless you take action, somebody might someday name a portion of a federal highway after you since the egregious taxes you will pay due to your passive attitude will result in a huge tax. (But wouldn't it be cool to have an offramp in your name?)

The age of a typical funeral home business is more than 60 years, and more than half of them were started before 1986. Why does that matter? Because prior to 1986, it was difficult to qualify for S corporation status. That year, however, Congress made S corp status relatively easier to obtain, thereby motivating many business owners to convert from C status to S status.

If you acquired a C corporation after 1986, here's why you must revisit that classification. Most businesses are transferred as the result of a sale agreement called an "asset sale," through which a company sells its tangible/intangible assets. If the selling company is an S corp, it will record a gain on the assets (to the extent the sale price is greater than the basis).

This usually involves the sale of the real estate. For example, imagine you sell your firm's real estate via an asset sale for $1 million. If you owned the real estate for more than 37 years, then your basis is probably close to zero. Therefore, you will recognize a gain of $1 million!

A C corporation does not provide a tax preference on capital gains, however, so it will record the gain and then pay tax on that gain, as it would for any other business earnings. Thus, the C corp will pay a flat federal tax of 21% on that real estate sale ($210,000). When the owner liquidates the C corporation, however, he or she will also pay a tax at the personal rate.

As noted earlier, if you inherited the business, then your basis will probably prove nominal. Thus, the liquidation of the real estate will involve a $790,000 distribution ($1 million–$210,000), but this will probably also be taxed at the personal capital gains rate of about 20% – a second tax amounting to roughly $160,000. In this example, therefore, the total tax on the sale of that C corporation business real estate amounts to roughly $370,000!

If an S corp sold that same real estate in an asset sale, it would be taxed at about 20%, resulting in a tax of approximately $200,000.

The good news is that if your business is classified as a sole proprietorship or partnership, you can elect to incorporate by signing your name on several documents, clicking your heels three times and lighting a candle to the accounting gods. In other words, it's easy! It is not a taxable event to switch from a sole proprietorship or partnership to a corporation (either S or C) or to an LLC.

DECISION TWO: RECOGNIZING REVENUE

You have a choice as to how your business will recognize income and deduct expenses: the *cash basis* or the *accrual basis.* As an individual, you are automatically taxed on the cash basis, which means you have income personally when you receive it (or are deemed to have received it), and you have expenses that might be deductible as you pay them. A funeral business can be taxed on the cash basis if it elects to do so, but this option wasn't always available.

Under the accrual basis, a business is deemed to have earned money when it has the right to receive it (regardless of when or if it is ever received). The business also has the right to a deduction when an expense is incurred. Most funeral homes recognize their income/expenses using the accrual basis.

In my opinion, that is not the best way to do it. I have examined the books of thousands of funeral homes and, in almost all cases, funeral directors pay their bills in a normal and timely manner. Sounds great, but most funeral homes do not get paid by families in that same expedient fashion, which is why businesses have *accounts receivable* (A/R).

A typical well-run funeral home will have between 10% and 15% of its annual revenue outstanding in accounts receivable. If a business has an annual revenue of $1million, it should therefore have approximately $100,000-$150,000 in A/R. At the end of the year, however, a business using the accrual basis will be taxed as if it received this money, even though it didn't. At a federal personal tax rate of 37%, that means the average funeral home business pays a tax of roughly $37,000-$55,500 more than it would if it used the cash basis.

Sure, this might be a one-year benefit, but it still involves money in your pocket that could benefit you every year of your operation until you sell the business and recognize the accounts receivable on your final tax return.

DECISION THREE: ANNUAL TAX PLANNING

Most funeral business owners wait until the end of year to start their tax planning and then ask:

- What can I buy that will generate depreciation?
- What A/R can I claim as bad debt and therefore deduct?
- How much of a bonus can I claim?

First, you should only buy equipment if you need it. Next, remember that if you do nothing, you pay a tax of 37% at most but retain 63% of the profit. No one is in a 100% tax bracket. Finally, understand that tax planning should be done throughout the year – not in December or, worse, after year-end!

To sum up, make good decisions about which business entity you select. Moreover, make progressive decisions about how to recognize your business income.

In addition, pay your taxes and adhere to the fine print beneath the signature line of your tax return, which will say something like: *I declare [or certify, verify, state] under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.*

Some people have actually struck this sentence from their tax return before signing it. That will not nullify your declaration – it will merely alert the Internal Revenue Service to come to your house.

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