✓Tax checklist for business startups

Starting your own business can be equal parts thrilling and intimidating. You can get started with this checklist of things you'll need to consider as you get started.

☑ **Pick your business structure.** If you operate as a business, you'll have to choose whether it will be taxed as a sole proprietorship, partnership, S corporation or C corporation. All entities except C corporations pass through their business income onto your personal tax return. The decision gets more complicated if you legally organize your business as a limited liability corporation (LLC). In this case you will need to choose your tax status as either a partnership or an S corporation. Each tax structure has its benefits and downsides – it's best to discuss which is best for you.

☑ **Apply for tax identification numbers.** In most cases, your business will have to apply for an employer identification number (EIN) from both the federal government and state governments.

☑ **Create a clear business intent.** This helps eliminate the risk your business will be deemed a hobby by the IRS. So open up separate bank accounts and credit cards. A true business is generally run for the purpose of making money and has a reasonable expectation of turning a profit. The benefit of operating as a business is that you have more tax tools available to you, such as being able to deduct your losses.

☑ **Select an accounting method.** You'll have to choose whether to use an accrual or cash accounting method. Generally speaking, the accrual method means your business revenue and expenses are recorded when they are billed. In the cash method, revenue and expenses are instead recorded when you are paid. There are federal rules regarding which option you may use. You will also have to choose whether to operate on a calendar year or fiscal year.

☑ **Create a plan to track financials.** Operating a business successfully requires continuous monitoring of your financial condition. This includes forecasting your financials and tracking actual performance against your projections. Too many businesses fail in the first couple of years because they fail to understand the importance of cash flow for startup operations.

☑ **Prepare for your tax requirements.** Business owners generally make quarterly estimated tax payments to the IRS. If you have employees, you'll also pay you and your employee's share of Social Security, Medicare, and income taxes through withholdings from their wages. Your personal income tax return will also get more complicated, so plan accordingly.

This is just a short list of some of the things you should be ready to discuss as you start your business. Knowing your way around these rules can make the difference between success and failure-but don't be intimidated. Help is available, so don't hesitate to call if you have any questions. ♦

tangiblevalues™
TAX AND ACCOUNTING PRODUCTS
Home of **Tax-Aid** and **HG Forms**
1.800.888.5803 • www.tangiblevalues.com

Inside this issue

Tax & Business letter
WINTER 2022

5 numbers that make or break a business

Actively monitoring a few key numbers is often what's needed to keep your company growing and prosperous.

Here are several key financial indicators to consider tracking in your company:

1 Order volume. Find the metric of orders that makes sense for your business. Then measure the number of orders versus last month and last year. Look at year-to-date numbers and compare them to last year. Are you selling more units over time? Tracking revenue alone may present a false picture, as revenue may be growing because prices have increased. If unit sales are declining, you might be losing market share.

2 Breakeven point. If you need $100,000 per month to cover fixed and variable costs, you need to know if you're selling enough products or providing enough services to break even. If you're dipping into reserves to cover revenue shortfalls, adjustments may be required. So calculate and know this number for your business.

3 Liquidity. Knowing the availability of cash is vital to every business. That's why reconciling the firm's bank statements in a timely fashion shouldn't be an afterthought. Ensure every month that your general ledger agrees with the bank's records of deposits and withdrawals. If a company is losing cash, the bank statements should tell the story.

4 Inventory turnover. This number shows how many times your company sells and replaces inventory during a given period. The higher the number, the better. For example, assume your company's cost of goods sold for 2022 is $100,000, beginning inventory on January 1, 2022 is $10,000, and ending inventory on December 31, 2022 is $15,000 (for an average of $12,500). Your cost of goods sold of $100,000 divided by $12,500 equals a turnover ratio of 8.0. Banks and investors love to look at this ratio...a higher number may indicate strong sales, while a lower number could indicate weaker sales or overstocking.

5 Payroll (and contractor) percentage. Take your total payroll costs (including benefits), add contractor costs and divide it by net sales. This percent of sales is then compared to budget and prior years. Try to maintain or shrink this percent. Don't forget to add part-time and contract workers to this total, as many businesses are relying more on these sources of workers in this tight labor market.

Over time, your business's vital numbers may change. The key is to know your company, identify changing conditions and be able to adapt. ♦

IRS TAX NOTES

Be on the lookout in early 2023 for Form 1099-K for sales above $600

The IRS published a reminder that if you earn income from selling goods and/or providing services, you may receive Form 1099-K for payment card transactions and third-party payment network transactions of more than $600 in 2022.

Under the old rules, a payment processor would send your business a Form 1099-K only if you exceeded both $20,000 in payments *AND* 200 or more total transactions with that particular processor.

The IRS also emphasizes that money received through third-party payment applications from friends and relatives as personal gifts or reimbursements for personal expenses is not taxable.

Interest rates increase for fourth quarter of 2022

Interest rates for the fourth quarter in 2022 will increase compared to last quarter. These rates include: 6% for overpayments (5% for corporations); 3.5% for the portion of a corporate overpayment over $10,000; 6% for underpayments and 8% for large corporation underpayments. ♦

Tax CALENDAR

WINTER 2022

January 17, 2023

- ❑ Due date for the fourth installment of 2022 individual estimated tax.

TAX COURT CORNER

Here's a roundup of several recent tax court cases and what they mean for your small business.

Be Reasonable About Compensation

(Hood, TC Memo 2022-15, 3/2/22)

Facts: Clary Hood and his wife founded and were the sole shareholders of Clary Hood, Inc., a C corporation. In 2014, Hood and his advisors concluded that Hood had been undercompensated in prior years. Hood and his wife received a $5 million bonus from the company in 2015, and another $5 million bonus in 2016.

The IRS claimed the bonuses were excessive, issued a notice of deficiency and assessed substantial underpayment penalties. The Tax Court agreed with the IRS, permitting bonus deductions of $1.36 million in 2015 and $3.68 million in 2016.

Tax tip: *While an employer may deduct compensation paid for services performed in a prior year, the compensation must be reasonable in the eyes of the IRS. So research what would be considered reasonable compensation in your industry and pay yourself timely. This is especially important for S corporations.*

Keep Those Receipts! - Part 1

(Wolpert, TC Memo 2022-70, 7/7/22)

Facts: Julian Wolpert, a former university professor, provided consulting services focused on civic engagement. On his 2016 and 2017 tax returns, Wolpert reported vehicle expenses, travel expenses, and payments to independent contractors totaling $63,380 and $54,150, respectively.

The Tax Court upheld the IRS's decision to disallow $38,046 of expenses in 2016 and $34,188 in 2017 and the resulting additional income tax. For the vehicle expenses in question, Wolpert's travel logs lacked specificity and detail as to the purposes of each business use of the vehicles. With regards to the other disallowed expenses, Wolpert was unable to substantiate the amount and business purpose.

Tax tip: *You must have evidence for all business expenses reported on your tax return. Consider either a physical or digital filing system to store all receipts and documents to substantiate your expenses.*

Keep Those Receipts! - Part 2

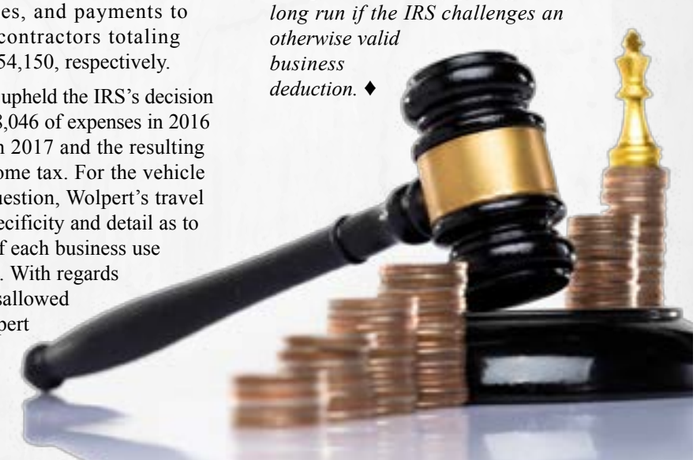
(Gonzalez, TC Summary Opinion 2022-13, 7/18/22)

Facts: Maribel Gonzalez, a California resident, had a full-time job but also commuted 800 miles round-trip every other weekend for her clothing design business. For the year in question, Gonzalez reported car and truck expenses of $12,256, which the IRS disallowed.

The Tax Court sided with Gonzalez, as she was fully prepared with adequate evidence to support her vehicle deduction. Gonzalez submitted as evidence to the Tax Court a mileage log detailing the dates traveled, distances traveled, and the purpose of each trip.

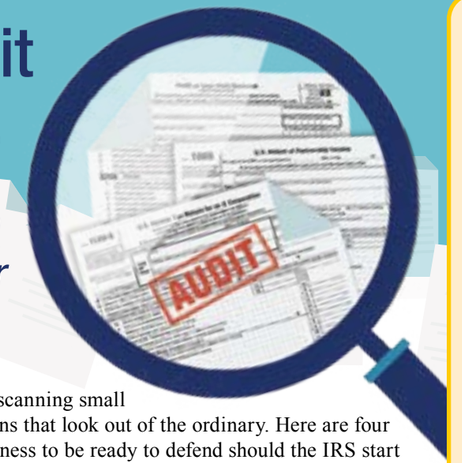
At trial, the taxpayer submitted a mileage log providing the dates traveled, distances traveled and the purpose of each trip. She also submitted service receipts corroborating the miles driven. In addition, she was a credible witness.

Tax tip: *This case illustrates how proper documentation can fend off an IRS overreach. Spending the time to accurately record information and gather documents as transactions or events occur may be tedious, but doing this can really pay off in the long run if the IRS challenges an otherwise valid business deduction.* ♦



IRS audit triggers

Be ready to defend your business



The IRS is always scanning small business tax returns that look out of the ordinary. Here are four areas of your business to be ready to defend should the IRS start asking you questions.

1. Business vs. hobby

Be ready to provide proof your business is truly a business and not a hobby. If the IRS decides that it's a hobby, your expense deductions could be limited while still being required to report the income. Have support for these questions:

- What is your profit motive?
- Are you an active participant in the business?
- Are you conducting the activity in a business-like manner?
- What expertise do you have in the services or products your business provides?

> "Be ready to provide proof your business is truly a business and not a hobby. If the IRS decides that it's a hobby, your deductions could be limited."

2. Reasonable shareholder salary

The IRS looks closely at businesses who avoid paying a reasonable salary to shareholders in order to lower their Social Security and Medicare tax bills. When determining salaries for shareholders, consider their experience, duties, responsibilities and time devoted to the business. Research comparable positions and salary ranges to pinpoint a fair salary. Save your findings and calculations as backup to provide in the event of an audit.

3. Contractors vs. employees

Make sure consultants and other suppliers are not employees in disguise. The IRS looks at how much control you have over the work being done – the more control you exert, the higher the likelihood you may have an employee versus a contractor. Penalties can be very steep if the IRS decides your consultant is really your employee. If in doubt, ask for a review.

4. Meal and travel expenses

Documentation for business meal expenses, as well as travel expenses, should include receipts, who attended the meal, and the business purpose of the meal. Bringing food in for business lunches rather than going out is a safe way to show business intent.

Knowing what the IRS is looking for helps you prepare should it turn its focus to your business. ♦

CASH FLOW CORNER

Prevent petty cash from turning into petty theft

Cash theft ranks as one of the most common frauds perpetrated on small businesses. To ensure your business is protected from theft, develop and implement a strong cash-handling policy. Here are some ideas to help create a working policy to prevent your petty cash from turning into petty theft.

- **Keep duties separate.** If one employee receives cash, someone else should prepare or oversee preparation of the cash deposit. A third person may record transactions in the company books. Although such separation of duties can be hard to implement in a company with few employees, creative owners will find ways to prevent such transactions from being concentrated in the hands of a single person. For example, you might cross-train staff so that today's accounting clerk is tomorrow's cashier. Or a supervisor might periodically assume one of those functions.
- **Document cash transactions.** Develop a cash count sheet that records the names of people removing money from a safe. Also document the date and time money is transferred for deposit. Include signature lines for all employees involved in the task. Have another employee routinely compare deposit slips and bank statements with cash count sheets. When cash is placed in a safe, record transactions with a similar detailed record.
- **Store cash securely.** Lock cash registers when not in use. Minimize cash on hand by requiring employees to periodically transfer excess cash to point-of-sale (POS) safes. Because such a system allows for one-way access only, it helps prevent cash skimming. POS safes should be unlocked only when cash is transferred to the back office safe. Limit safe combinations to authorized employees and ensure that combinations are routinely changed.
- **Conduct internal audits.** Employees should expect their cash-handling activities to be scrutinized. Inform staff that there will be surprise cash audits and detailed reviews of company books if irregular transactions come to light. If your company uses a currency counting machine, you might also print and review a sample of cash-count reports.
- **Communicate policies.** Develop and communicate a clear cash policy with everyone in your company. With a little focus, you can greatly reduce the risk of mishandled or disappearing cash. ♦