# 10 Tax Essentials for Growing Businesses

By Judy Vorndran, J.D., CPA

TaxOps

Tax Intelligence

With taxes a top-three expense for most organizations, managing the size of a business's obligation to the U.S. and state taxing authorities could mean the difference between a good year and one where the business loses ground. Managing tax functions in light of growth initiatives takes ongoing attention to minimize tax burdens and maximize cash flow. Business leaders should consider the following 10 issues in pursuing business expansion goals.

## Checking off growth considerations

- ❑ Business formation
- ❑ Compensation and benefits
- ❑ Accounting method review
- ❑ Research & development tax credits
- ❑ Other federal credits
- ❑ State and local tax issues
- ❑ International operations
- ❑ Mergers, acquisitions & other transactions
- ❑ Net operating losses & other tax attributed

## Judy Vorndran, Esq., CPA

Judy Vorndran leads the state and local tax practice (SALT) at TaxOps. She helps clients and tax professionals navigate the morass of state and local tax issues with the goal of making it less "taxing!" She is a nationally recognized thought leader and award-winning instructor with a steady focus on finding ways to simplify complex state and local tax issues and resolve areas of state tax controversy. She can be reached at 720.227.0093 or JVorndran@TaxOps.com.

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Starting a new business venture – either through an existing organization or a new one? From the outset, owners should consider the tax ramifications and administrative burden of forming a C corporation, S corporation, limited liability corporation (LLC), partnership, or other form of legal entity before making a choice.

Each entity has its own set of tax benefits and limitations that may affect the growth and strategic objectives of the company. An LLC that expands operations to a half-dozen states would impose on its owners a tax filing requirement in every state that the organization is doing business. At some point, the cost of complying with state filing requirements may outweigh the additional tax burden of being treated as a C corporation, and the owners may choose to reorganize the business as a C corporation.

Choosing the right type of legal entity requires that owners look further down the road and consider the tax implications of various forms of ownership on the business, employees, and the owners themselves. The long-term goals of the owners, debt-to-equity financing, and an exit strategy should also be considered when forming an organization.

# 1

## Business formation

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## Compensation and Benefits

Compensation and benefit issues apply to all businesses, regardless of where the business is in its life cycle. Consider the following:

- Salary, commission, bonus, or equity compensation to incent and compensate top performers
- Staffing up with employees, which requires the administrative burden of withholding taxes and unemployment insurance, versus independent contractors
- Capital gains treatment for early exercise provisions
- Qualified pension plans, including 401(k) and IRAs, to maximize owner deductions and minimize employee deductions
- Equity compensation, such as unrestricted or restricted stock, stock options, employee stock purchase plans, and profit interests

Equity compensation, especially in the form of stock options, has had far-reaching implications in recent years for businesses that earn income in one year and defer compensation to a subsequent year. If handled improperly, these types of payments can result in significant penalties to the recipient. Since this arrangement is a form of compensation, the employee or service provider generally must report ordinary income when the option is exercised. The business receives a tax deduction for the ordinary income portion reported by the employee or service provider.

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# Accounting Method Review

Accounting methods vary based on the growth stage of the organization and its business operations. For example, a start-up organization may use a cash basis financial statement for management purposes while using an accrual basis financial statement for banking needs. Tax returns may be filed with either method (within certain limitations), which gives an organization the flexibility to influence taxable income. There are a number of additional accounting methods to evaluate.

Transaction costs. Transaction costs of a merger or acquisition vary widely from transaction to transaction; some costs are deductible while others must be capitalized. Understanding the nature of the costs is critical to maximizing the amount of the deductible costs associated with the transaction.

Deferred revenue recognition. In situations where advanced payments are received for services to take place over a period of time, such as two to three years, businesses may have the opportunity through specific elections to defer a significant portion of the cash received in advance of earning the revenue.

Election opportunities for expense recognition. For expenses that occur each year, the recurring item exception gives organizations an opportunity to accelerate deductions.

Depreciation strategies. Depreciation strategies – methods, lives, expensing elections, and bonus depreciation – differ based on the life cycle of the business as well. Depreciation can be accelerated or slowed-down to better manage current taxable income or net operating losses.

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# Research & Development Tax Credits

Research and development (R&D) can be a significant component of deductible expenses. Tax credits are available for certain research activities as long as the business has completed a thorough analysis of creditable activities per IRS guidelines. Businesses have two options – take 100 percent of the credit and no R&D expense deduction, or deduct 100 percent of R&D expenses and take a reduced credit. In making this decision, organizations should identify expenses for capitalization or deduction purposes; calculate credit limitations; and consider potential alternative minimum tax (AMT) issues.

R&D credit is a hot button for the Internal Revenue Service. Taxpayers that claim the R&D credit must closely monitor changes in treatment as they occur either independently or with the help of an advisor that tracks changes. In filing 2010 returns, for example, companies that elected to take the reduced credit may be able to avoid AMT payments and penalties. Businesses that elected to take the full credit, however, may have increased their taxable income into the AMT range, resulting in AMT payments and limiting AMT credit options.

The federal and state governments offer credits for energy – such as solar, biofuels, and biodiesel – and orphan drugs that companies too often fail to take advantage of due to either the complexity of the filings or that they did not know the credits were available. Businesses that track renewable credits, emerging credits, and credit sunset dates are better able to plan spending that coincides with credit maximization and tax minimization strategies.

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# Other Federal Credits

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# Other Tax Minimization Strategies

Growing business may be able to take advantage of a number of potential opportunities for tax savings among the following tax minimization strategies.

Domestic production activity deductions. Businesses engaged in qualified production activities in the U.S. may be eligible for a tax deduction of up to 9 percent of taxable income. The type of activities that qualify as "domestic production" is fairly broad, and include construction (except cosmetic); engineering or architectural services; and the lease, rental, license, sale, or exchange of property that is manufactured or produced in the U.S.

Cost segregation to accelerate depreciation. Certain assets may qualify for accelerated depreciation, which allows a business to take larger tax deductions over a shorter period of time. Reclassifying personal property asset costs (that are often lumped together within real property assets) to the shortest possible depreciable life can accelerate depreciations, thereby increasing an organization's cash flow and lowering the cost of capital in the first few years following a project or purchase. For example, a business that spends $10 million on a new building can depreciate the total cost over 39 ½ years. If, however, that same business segregated out specific costs related to wiring and other fixed components that depreciate in five to seven years, the business could maximize their depreciable tax deductions today and reduce their current income tax obligation.

Meals and entertainment deductions. Meals and entertainment expenses generally are limited to 50 percent deductions. Exceptions exist, though, that can increase the percentage that businesses may write off. The expenses associated with an annual holiday party or picnic, for example, fall under an exception allowing for these items to be fully expensed.

Budget deficits across the nation have state and local authorities lowering the threshold requirements for businesses to file and pay taxes. Among the issues growing entities may face on the local front are:

- Reduced thresholds at which businesses are required to file income and sales taxes within a jurisdiction (nexus);
- Economic presence;
- Tax incentives and credits, such as enterprise zones where relocating businesses may benefit from a reduced tax structure;
- Personal and real property taxes; and
- Other tax minimization strategies around structure, location of activities, and intercompany transactions.

The issue of nexus is particularly sticky right now with regard to sales and use taxes. Businesses with a physical presence or continuous activity that meets a state's nexus threshold test may be subject to state filing or reporting requirements. Online retailer Amazon is actively arguing the definition of economic presence with states and in the courts to avoid state and local tax payments. Amazon has been opting to pay up or pull out on a state-by-state basis, and has embarked on a campaign to negotiate a sales tax exclusion in each state where the online giant has a warehouse fulfillment center. The nexus debate and long-term ramifications of Amazon's fight will affect all companies that do business across state lines.

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# State and Local Tax Strategies

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# International Operations

A business's international operations should be assessed from both the U.S. and international tax perspective to determine how foreign operations should be structured. The IRS "check the box" rules generally allow a business to select an entity classification for its foreign operations. If, for example, a U.S. company begins operations in a foreign country as a C-type corporation, it can generally determine how the foreign operations will be treated for tax purposes from a U.S. tax perspective – as a separate company or a "disregarded" entity.

Additional international tax considerations for businesses with operations outside the U.S. may include:

- Intercompany sales and transfer pricing
- Foreign tax credits
- U.S. and non-U.S. filing requirements

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# Mergers, Acquisitions and Transactions

Mergers, acquisitions, joint ventures, and other transactions can be analyzed to maximize deductions of goodwill and intangibles acquired in the transaction. Companies that plan ahead can make sure that they are papering the transaction to get the best tax treatment in the purchase or sale of a business's assets or stock. Transactional items to assess may include:

- Asset versus stock purchase or sale
- Tax free reorganization
- Tax basis of assets
- Use of tax attributes, such as net operating losses and credits
- Treatment of acquired goodwill and intangibles
- Analysis of "earnings and profits"
- State and local tax implications that differ from federal tax treatment
- Sales taxes applicable to the transaction

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# Net Operating Losses & Tax Attributes

Changes to a company's ownership structure, including how a company raises money, can limit the company's use of net operating losses (NOL) and other tax credit carry forwards in future years. To preserve NOL, a company should contemplate current year elections and other taxable income calculations that can affect its NOL.  For example, if a company is already in a taxable loss position, taking advantage of bonus depreciation will increase the NOL. Later, if the same business entity has a more than 50 percent change in control or ownership, limitations may restrict the amount of NOL that can be used, potentially eliminating the benefit of the bonus depreciation deduction.

Though there is currently a 20-year carry forward of NOL for federal purposes, many states have different carry forward periods. Other states have suspended the use of NOL carry forwards. So even though you may have sufficient tax losses to offset regular federal taxable income, sizable state income taxes may still be due.

Let’s continue the conversation


# Judy Vorndran

Partner, State and Local Tax
720.227.0093
JVorndran@TaxOps.com


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