

Staying ahead of the tax curve in 2005

By Jim Bailey

As we approach another tax season, it's always advisable to evaluate your overall business plan with an eye toward the most beneficial positioning from a tax standpoint.

Whether you are a sole proprietor, real estate developer, an LLC property management firm, an architect, attorney, owner of a mortgage company or a manufacturer, this new year is an excellent time to take stock and consider different strategies that will make this and future years more profitable for you. As you know, tax planning is critical to maximizing your bottom line. In doing so, you should be aware that there are significant changes in the tax code that may work to your advantage.

Where do you start? At the very beginning, check with your tax advisor and be certain that your business structure is the right one for you. There are a number of different entities to choose from: C-Corporation, S-Corporation, sole proprietorship, or LLC (Limited Liability Corporation). Each offers distinct advantages. If, for example, commercial real estate is your industry, the LLC may be the most beneficial option. Determine which entity suits your needs best.

Once you have done that, the next step is to evaluate the accounting methods used in your business and determine which method(s) might be most advantageous. Businesses, in general, use either the "cash" or "accrual" method as their overall method of accounting. Under the "cash" method, revenue is recorded when the income is received rather than invoiced. Under the "accrual" method, revenue is recorded when invoiced. Thus, the timing of revenue recognition and imposition of tax liability is different depending on the method being used.

If a company maintains inventory, there are two different options to consider in valuing the amount of inventory on hand at year-end. One is FIFO, or "First In, First Out" and the other is LIFO or "Last In, First Out." The chosen method will make a difference in yearend numbers and the calculation of the company's "cost of goods sold"(COGS). The larger the COGS deduction, the better.

For contracting and construction businesses, accounting method options include the "completed contract" method or the "percentage of completion" method. The completed contract method can be used until average annual gross receipts for the three previous tax years exceed \$10 million. This accounting method does not require a business to recognize revenue from a job until it is completed. Those businesses using the percentage of completion method must recognize revenue as contract costs are incurred.

Businesses should also evaluate whether a calendar year or fiscal year end makes better economical and tax sense.

All of these are general suggestions for a new year. However, there is also new legislation which may also significantly reduce your tax liability.

1. New Deduction for Domestic Producers

To offset the loss of the tax breaks to Foreign Sales Corporations (FSCs) and Extraterritorial Income (ETI), the new law creates a 9% federal income tax deduction for domestic producers. The new write-off is phased in as follows: 3% for tax years beginning in 2005 and 2006, 6% for years beginning in 2007 through 2009 and the full 9% for years beginning in 2010 and beyond. The deduction equals the applicable percentage (3%, 6% or 9%) multiplied by the lesser of qualified production activities income for the year or taxable income for the year. In any case, the deduction cannot exceed 50% of wages for the year.

This new deduction is not limited to C corporations; it is also available to S corporations, partnerships, sole proprietorships, cooperatives, estates and trusts with qualifying domestic production schedules. Nor is the deduction limited to taxpayers that report to foreign countries. It's available to many businesses which will be unaffected by the repeal of the FSC/ETI regime.

Because the definition of "qualified production activities" is very broad, many taxpayers will qualify for the new write-off, including (but not limited to) those engaged in these industries in the United States: traditional manufacturing of tangible personal property, construction, civil engineering and architectural services for construction projects, software production and farming.

2. Extension of current Section 179 deduction rules.

The new law extends the current maximum Section 179 deduction (\$102,000 for 2004, indexed for inflation) for an additional two years, through tax years beginning in 2007. For tax years beginning in 2008 and after, the maximum deduction is scheduled to fall back to only \$25,000 unless Congress takes further action.

3. Reduced Section 179 deduction for SUVs.

The new law places a \$25,000 limit on the Section 179 deduction for SUVs with gross vehicle weight ratings of 14,000 pounds or less. Previously, SUVs with gross vehicle weight ratings of more than 6,000 pounds could qualify for the full deduction (\$102,000 for 2004). This unfavorable change only affects SUVs placed in service after October 22, 2004. The new rule doesn't apply to vehicles that meet certain exceptions. Many pickups with full-sized beds, for example, are not affected by the rule change. Vehicles that fall under the tax-law exceptions still qualify for the full Section 179 deduction, as long as they have gross vehicle weight ratings in excess of 6,000 pounds.

4. 15-year depreciation for leasehold improvements.

Under current law, most leasehold improvement costs for nonresidential real property must be depreciated over 39 years. The new law establishes a 15-year depreciation period (using the straight-line method) for qualified nonresidential leasehold improvement property. This favorable new rule applies to qualified leasehold improvements placed in service after October 22, 2004 and before 2006.

5. S Corporations – number of shareholders.

The new law allows family members to be treated as one shareholder for the purposes of determining the number of shareholders of an S corporation. Even better, the new law increases the maximum allowable number of shareholders from the current 75 to 100. These changes are effective for tax years beginning after 2004.

In addition to these new provisions, businesses have been able to provide certain tax-favored fringe benefits. Among these are the following:

1. As an employer, you may deduct the cost of providing group-term life insurance coverage to employees. Premiums up to \$50,000 of coverage (per employee) generally are excludable from employees' incomes.
2. Premiums paid for employees under a group health plan are also tax deductible by the business and generally may be excluded from employees' incomes. Premiums paid for partners and more-than-2% S corporation shareholders cannot be excluded but are otherwise deductible on their individual tax returns.
3. As a business owner, you may deduct contributions that you make to a qualified retirement plan on behalf of yourself and employees, within limits.
4. For businesses with home offices, a business owner who uses an area of his or her home regularly and exclusively for business purposes may be able to claim a home office deduction. And the IRS now says that a home office may not have to be treated as business property when the residence is sold.

As always, you should consult with a tax specialist in making any changes to your structure or accounting methods. Obtaining advice from a professional will assist you in understanding the complex federal and state tax rules. A new year is always a good time to re-evaluate and be certain you are doing the most you can for your business.

(Editor's note: Jim Bailey is a principal in the Rockland, MA CPA firm Needel, Welch & Stone, P.C., which works with businesses, individuals and not-for-profits on matters of taxation and business consulting. 1001 Hingham St., Rockland, MA. 781-982-1001. www.nwscpas.com)