

Module 2.2: Definitions and Planning

Most taxpayers who start businesses are not professional bookkeepers and likely don't want to spend valuable business time keeping records. But what business owners should know is that keeping good records can help save money in the long run and increase your profits. To accomplish this, it takes planning and knowing how to organize your records.

Properly organizing your records will allow you to do several major things:

- Know how much profit your business is making at any given time.
- Discover where money is being wasted to help increase your profits.
- Reduce your tax liability by taking advantage of tax breaks.
- Help in the preparation of financial statements, such as Income Statements, Profit & Loss Statements and Balance Sheets.

In addition, this may help avoid additional tax, penalties, and interest should the tax authorities not allow your reported tax items due to a lack of convincing records

Many people think that the accounting part of a business is just buying some software and then start plugging numbers in. That couldn't be farther from the truth. So we are going to start at the beginning. The things that you should decide on before you even pick up a pencil, start putting numbers on a spreadsheet, or buying some accounting software.

So, we are going to discuss some of the basic decisions that you will have to make before starting your accounting system. They include:

- Your Tax Year
- Your Accounting Method and
- How to Keep Inventory

One of the first things you will need to do is designate a tax year. A tax year is usually 12 consecutive months, with the exception of the first and last year of the business, which may be shorter.

There are two kinds of tax years:

- A calendar tax year is the 12 months beginning on January 1st and ending on December 31st. This is used by most small businesses.
- A fiscal year is either 12 consecutive months ending on the last day of any month except December. A lot of large corporations end their fiscal years at the end of March or June.

Some types of businesses are required to use the calendar tax year. For instance, if the business:

- Keeps no books - I doubt they will be in business long....
- Has no annual accounting period.
- Can't qualify to use a fiscal year.
- Or is required to use a calendar year because of Internal Revenue Code or the Income Tax Regulations. Your business format can also determine what kind of tax year you can use.

So, let's look at the common legal formats and the rules for each:

- Sole Proprietorships are required to have the same tax year as the business owner. Individuals use a calendar year, so sole proprietorships must use the calendar tax year.
- Partnerships must use same tax year that it's partners use. To determine this, the business must first look at the tax years of the partners holding the majority interest (more than 50%). If there is no partner that owns more than 50% of the partnership, the partnership would use the tax year of all its principal partners (those who have a 5% or more interest in the partnership).
If there is no majority partner and the principal partners don't share the same tax year, the partnership must use a tax year that results in the least aggregate deferral of income to the partners. That involves a whole set of calculations that we don't need to address here. Most small business partnerships are composed of individuals who all use the calendar tax year and thus, the partnership would also. You only get into other scenarios when corporations or another partnership owns part of your partnership.
- S corporations generally will use the calendar year. There are provisions for an S corporation to elect something other than a calendar year, if eligible, but the request must be approved by the IRS.
- C corporations establish their tax year when they file their first tax return and may choose a calendar or fiscal year.

Once a business has adopted a tax year, the business may have to get IRS approval to change it. (For the curious, you file Form 1128 or Form 8716, depending on your situation.) The important thing to know is that it could present some complicated tax implications for the year of change. That's why I wanted to discuss tax years, so you can make a proper choice for you starting out and skip a problem later on.

The second thing you need to decide on is your Accounting Method.

An accounting method is a set of rules used to determine when and how income and expenses are reported. The three choices are *cash, accrual, and hybrid*. The business must use the same accounting method from year to year unless an application to change it is sent to the IRS and approved. So it is best to select how you want to record your income and expenses from the beginning. It is also one of the questions you must answer on your business tax return.

The most common form of accounting for small businesses is the **Cash Method**. Under the cash method, income is reported when you receive the money. Expenses are deducted or capitalized when paid for. Like most things in business and taxes, there are some rules for accounting methods.

There are some business formats not allowed to use the cash method, including any combination of methods that include the cash method. These include:

- A C corporation with average annual gross receipts for the three preceding tax years exceeding \$25 million.
- A partnership with a C corporation as a partner, and the partnership having average annual gross receipts for the three preceding tax years exceeding \$25 million.
- The business has a way of minimizing a taxpayer's tax liability such as an employee-sponsored 401(k) plan which reduces taxable income.

There is also a **Gross Receipts Test**. A corporation or partnership, other than a tax shelter, that meets the gross receipts test can generally use the cash method. You meet this test if the average gross receipts for the three preceding years were \$25 million or less. You simply add the gross receipts together for the last three years and divide by three to arrive at this.

Since the vast majority of small businesses do not reach these thresholds, (even if that is what we may be working towards), most use the cash method.

There are also **Special Rules for Farming Businesses**. Generally, farmers are allowed to use the cash method for their farming business. The exception to this is if a C corporation is in the farming business or a partnership has a partner that is a farming C corporation, then you have to use the accrual method - unless you meet the gross receipts test.

The second method of accounting is referred to as the **Accrual Method**. Under an accrual method, income is reported when it is earned or the invoice sent. For instance, if you send the invoice in August, but are not paid until November, it would be counted as August income. Under the cash method, it would be considered November income.

Likewise, expenses are deducted or capitalized when you purchase them, not when you pay for them. (Using a credit card to purchase is considered to have paid for them and not when the credit card payment is made.)

Anybody can use the accrual method if they want to, although most business that have gross receipts of over \$25 million must use it.

The third method of accounting is referred to as the **Hybrid Method**. If inventory is a necessary part of your business to generate income, then the business is generally required to use an accrual method for purchases of the inventory and all related sales of that inventory. Then, the cash method may still be used for all other items of income and expenses, such as rent, office supplies, or general services.

These are the general rules that have been in place for decades. However, the 2017 Tax Cuts and Jobs Act (TCJA) expanded the number of small businesses that can use the cash method for everything. Small business that meet the gross receipts test are now exempt from the inventory requirements, the uniform capitalization rules (which I was so glad to see because they were a pain), and the requirement to use the percentage of completion method (which we don't even need to discuss.)

Essentially, because small businesses who meet the gross receipts test (under \$25 million) are exempt from the inventory requirements, they may choose whether or not to keep an inventory. You can simply expense them as material or supplies *in the year in which they are first used or consumed* in the operations of the business.

Advantages of Keeping Inventory

That said, there are definitely some advantages to go through the extra work of keeping track of your inventory, depending if you are in a retail business or a manufacturing business. Let me give you some examples.

Let's say you have a retail store (physical or on-line) and you buy \$100,000 of merchandise during the year. According to your books, the cost of what you sold during the year was \$70,000. When you did your year-end inventory count, the cost of what you still had in stock was \$25,000. What happened to the other \$5,000 you purchased? That is \$5,000 in lost profits you would not have known about unless you kept inventory records. That's how you protect your profits.

I remember working for a large supermarket chain for a few years and we would have to inventory the entire store four times a year. It was always amazing to see how much "walked off" or was thrown out without accounting for it. Taking inventory allows you to see this and create procedures to prevent losses in the future.

When you manufacture products, you have to count all of parts that makeup the products you make. Sometimes if you have a lot of parts included in each finished product, that's a lot of counting at the end of the year, so you may want to develop a plan to keep each part of the inventory or bins counted as you go along. When we get to module 3 and start discussing the Cost of Goods Sold section of the tax return, you will discover how to determine if you are really making a profit or not on your products.

Let me briefly discuss it here to show the advantages. When figuring the Cost of Goods Sold, in addition to the cost of the parts, you also add the other costs of manufacturing, such as rent for the manufacturing facility (separate from office space), costs of labor to assemble the products, electricity to power the machines, etc. Every single thing you had to spend just to create your products.

Then you take your beginning inventory, add your part purchases for the year, add your cost of operation, then subtract your ending inventory. This is going to give you your total cost on the products your manufacture. Divide that by your total product sales for the year and you'll will see your profit percentage. If your profit percentage is only 5%, you may want to consider raising your prices or finding a cheaper source for your parts. Without keeping inventory, there is really no accurate way to discover this and the success of your business depends on it. And remember that the cost of doing business such as office expense, licensing, and taxes also have to come out of that profit.

All right, if you decide to keep track of your inventory, there are some things you need to know. The first is that at a minimum, the inventory must be valued at the beginning and end of each year. The end of year inventory becomes the beginning inventory for the following year. Next, the first step in valuing your inventory is to identify the cost of items in inventory. There are three ways to identify the cost:

- *Specified identification method* is used when it is possible to identify and match the actual costs to each item in your inventory. This could be difficult unless you had a small number of items for sale or designed some system where you could easily determine what you paid for each. If it is not possible to specifically identify items with their cost or the same types of goods are intermingled in inventory and can't be matched to specific invoices, you can choose between FIFO or LIFO methods.
- *The First In, First Out, or FIFO method* assume the items purchased or produced first are the first items sold, consumed, or otherwise disposed of. FIFO assumes that the remaining inventory consists of items purchased last. So, the items in inventory at the end of the tax year are matched with the costs of similar items that were most recently purchased or produced.
- *The Last In, First Out, or LIFO method* assumes the items of inventory purchased or produced last are the first items sold, consumed, or otherwise disposed of. Items included

in closing inventory are considered to be from the opening inventory in the order they were purchased. Often, in an inflationary market, lower, older costs are assigned to the cost of goods sold under the FIFO method, which results in a higher net income than if LIFO were used. The rules of using LIFO are very complex and should *not* be used unless there is a specific need for it. Okay, once you have determined how you are assign the cost of each item of inventory, you must choose a method to value it. These methods include:

- Most people use the *Cost Method*, as it is the simplest. All direct and indirect costs associated with the inventory must be included with it. For merchandise on hand at the beginning of the tax year, cost means the ending inventory price for the goods from the previous year. You then add merchandise purchased during the year, less any discounts plus any shipping or other costs incurred in acquiring the goods. For merchandise produced during the year, most means all direct and indirect cost associated with it as we discussed earlier.
- In the *Lower of Cost or Market Method*, the business owner would compare the market value of each item on hand on the inventory date with its actual cost and use the lower of the two as the inventory value. The market value of inventory is essentially the replacement cost of that inventory or the amount of money it would take to replace the inventory in the open market. This is primarily used by companies that have inventory sitting on the shelves that have lost a great deal of value since the time it was purchased and need to make their financial statements look better for investors.
- The *Retail Method* used the total selling price of goods on hand at the end of the tax year in each class of goods, reduced to the approximate cost by using an average markup expressed as a percentage of the total retail selling price. Yes, it is as complex as it sounds and something a small businessperson will never need to use.

I realize that there is a lot of information here that most of you will never use. But my intention here is to give everyone enough information to help them not make a mistake that will cost them money and to know how the business may need to change as you grow larger.

Okay, now that we know the basics of *all* businesses, we need to discuss how to setup the tasks for your business and how to begin organizing your paperwork to provide you with the maximum benefits. We'll discuss this in module 2.3.

If you have a partnership or corporation, you are generally required to produce financial reports. To accomplish this, we need to discuss the Chart of Accounts. This is something that you really need to think through to be able to fully keep track of where your business is making or losing money, yet very few people I've helped over the last two decades really understand its importance. So, I've decided to make one whole module just on creating a Chart of Accounts

and how it can be improve the way your business is run and your profitability, which will be in module 2.4.