

Taxes and Record Keeping For Small Businesses

Those individuals who have an entrepreneurial spirit embark on their business ventures for any of a multitude of reasons – freedom, unlimited opportunity, financial independence, or to provide a unique product or service. However the success of any venture requires careful consideration and planning. The following chapters are designed to provide you with the basics as you begin your adventure. Congratulations on beginning this process – we wish you much success in your endeavor!

Contryman Associates, P.C., CPAs is one of the oldest and largest local Certified Public Accounting firms in Nebraska. The firm was founded in 1939 and has grown to include offices from Grand Island to Scottsbluff. Contryman Associates provides a full range of accounting and auditing, tax, and management services. In addition, we have strong affiliations with Contryman Wealth Advisors, a financial services firm, and Advanced Computer Services, a full-service technology firm. We believe we are a progressive, well-rounded organization that is able to assist you with a wide range of needs. Our team is comprised of individuals with knowledge and abilities in many areas. Most importantly, we truly want to see you succeed on your endeavor because your success translates into our success. Look over our web site, <http://www.capc.com> for additional information on the services provided by us. Give us a call and allow us to provide *Solutions for Your Success!*

Contryman Associates, P.C., CPAs
615 West 1st Street
P.O. Box 700
Grand Island, NE 68802
Phone: 308-382-5720
Fax: 308-382-5945

Contryman Associates, P.C., CPAs
315 W 60th St; Suite 500
P.O. Box 1746
Kearney, NE 68848
Phone: 308-237-5930
Fax: 308-234-4410

Contryman Associates, P.C., CPAs
1001 West 27th
P.O. Box 2246
Scottsbluff, NE 69363
Phone: 308-635-7705
Fax: 308-635-0599

Contryman Associates, P.C., CPAs
Geneva, Nebraska 69361
Phone: 402-759-3002
Fax: 402-759-4342

Contryman Associates, P.C., CPAs
2215 West 12th
P.O. Box 2026
Hastings, NE 68902
Phone: 402-463-6711
Fax: 402-463-6713

Contryman Associates, P.C., CPAs
500 North Washington
Drawer H
Lexington, NE 68850
Phone: 308-324-2368
Fax: 308-324-2360

Contryman Associates, P.C., CPAs
1611 16th Street
P.O. Box 191
Central City, NE 68826
Phone: 308-946-3870
Fax: 308-946-3870

Contryman Associates, P.C., CPAs
103 South Brown
Clay Center, NE 68933
Phone: 402-463-6711
Fax: 402-463-6713

Providing Solutions for Your Success
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This publication is issued in order to provide the reader with an informative summary of business considerations relative to owning a business. Do not attempt to apply this general information to your specific situation without obtaining the services of a competent professional advisor.

~ Contryman Associate, PC, CPA's

CHAPTER 1: SELECTING A LEGAL ENTITY

Your first decision as a business owner is not an easy one. In fact, it may be the most important! The decision facing a new business owner is the choice of entity. Available options include proprietorships, partnerships, corporations, and limited liability companies. The selection of an entity type must include consideration of the following:

1. Nature of the business
2. How the business organizer wishes to participate in the business
3. The number and relationships among the business organizers
4. Information regarding the assets contributed to the business
5. Necessity for legal protection
6. Taxability issues
7. Handling of benefits (health insurance, etc.)

All of these items, among others, must be carefully weighed to determine the most beneficial form of operation for a business. There are advantages and disadvantages to each type of entity. The important thing to remember is that not all businesses are identical. Therefore, what may be an advantage to one may be a disadvantage to another.

Sole Proprietorships

Simplest form of business
Minimal legal involvement to setup
Unincorporated and is owned by one individual
The liabilities of a business of this type become your personal liabilities
The proprietor bears all associated risks with doing business
Taxes are calculated and paid via a Schedule C/F on your personal income tax return
Generally required to pay self-employment tax on the profits
No liability protection

Partnerships

Two or more persons carrying on an unincorporated business relationship
Legal involvement to create Partnership Agreement
Each person contributes cash, property, or skills in exchange for share of the profits
Not a taxable entity, although must file separate tax return
Each partner reports their share of partnership income/loss via a Schedule E on their personal income tax return
Generally the most flexible form of business for tax purposes

Corporations

Each shareholder transfers money, property, or both in exchange for stock
Can have one or more shareholders
Legal involvement to create Articles of Incorporation, By Laws, Annual Minutes
Liability generally limited to corporate assets
Relatively easy to transfer ownership

Two types: C corporation and S corporation

C corporation - taxable entity all its own

business profits are taxed to the corporation

shareholders cannot easily get cash out of corporation tax-free

S corporation - filed election with IRS

treated similarly to partnerships for tax purposes

ownership limitations

Limited Liability Companies

A hybrid of a corporation and partnership

Liability protection

Disproportionate distributions

COMPARISON OF ENTITY TYPES

	Proprietorship	Partnership	Corporation	LLC
Liability	Unlimited	Unlimited unless a limited partner	Generally limited to corporate assets	Limited to investment in LLC
Taxability	...to proprietorto partner	C corporation – to corporation S corporation – to shareholderto partner
Continuity	Ceases at death	Terminates if 50% change	Indefinite	Generally not
Tax Year	Must use tax year of proprietor	Must use tax year of majority of partners	C corporation – any unless a PSC S corporation – calendar year unless make election	Must use tax year of majority of partners
Maximum tax rate	35% (for 2003)	Taxed at individual level	C corporation – 35% S corporation – taxed at individual level	Taxed at individual level
Self-employment income to owners	Yes	General partners – yes Limited partners – no	No	Uncertain
Accounting method	Unrestricted	Unrestricted	C corporation – restricted S corporation – unrestricted	Unrestricted
# of owners	n/a	Unlimited	C corporation – unrestricted S corporation – 75	Unlimited
Eligible owners	n/a	Unrestricted	C corporation – unrestricted S corporation – restricted	unrestricted

CHAPTER 2: REGISTERING WITH THE TAX AUTHORITIES

After selecting your entity type, your next step is to register with the various tax authorities. These taxing authorities include the Internal Revenue Service, the Nebraska Department of Revenue, and the Secretary of State. Registration with other states may be required if you plan on doing business outside of Nebraska.

Secretary of State

By this point, you have probably chosen a name for your new business. Before you can call that name yours, you must communicate with the Secretary of State to determine if that name is available. This prohibits more than one business from operating under the same name. Generally, this process is handled by your legal counsel and involves a nominal filing fee.

Once you have selected an available name and your organizational documents have been filed with the Secretary of State, you must begin the process of filing for identification numbers.

Internal Revenue Service

Just like you, personally, have a social security number, your business may be required to have a Taxpayer Identification Number (TIN). A TIN is generally required when you have employees or if you do business in a form other than a proprietorship.

To obtain a TIN, you must complete IRS Form SS-4. This form should be completed as soon as possible after determining your entity type or use of employees.

Form SS-4 is required to be filed with an IRS office based on the location of your place of business. This form can be done online, via telephone, faxed, or mailed. Mailing generally requires approximately 4-5 weeks for a reply. If you provide the IRS with your fax number and fax in your request, you will receive notification of your TIN assignment within approximately 5 days. Applying via telephone or online will generally allow you to get your ID# immediately or, at the very least, the same day. No fee is required with this form.

Nebraska Department of Revenue

After receiving your TIN from the Internal Revenue Service, your next step is to file for a Nebraska identification number. Nebraska Form 20 is used to obtain this number. It is important to note that receipt of your Federal TIN is required before filing this form as the State requires you to provide them with your Federal TIN.

This form encompasses most state tax programs including sales tax, income tax withholding, and several other miscellaneous tax programs.

Other registration requirements

Unemployment tax - If you pay wages, you may also be subject to unemployment tax. The state requires a separate identification number. You should consult your accountant to determine whether you are liable for this tax because the rules vary depending on the form and type of your business.

Personal property tax – The State of Nebraska requires personal property tax to be paid on business assets. Generally the initial filing must be done voluntarily. In subsequent years you will receive a pre-printed form from the county in which you are located.

CHAPTER 3: ACCOUNTING AND BOOKKEEPING

Probably one of the most unappreciated parts of your business is the accounting and bookkeeping system. A good record keeping system that's kept current and is regularly summarized is the most reliable source of information about your business. With an up-to-date and complete bookkeeping system, you'll be able to know whether you are making a profit, barely breaking even, or "losing your shirt."

Why even keep records? Your records system is intended to provide you with a constant flow of information about the state of your business. It should provide you with a quick and accurate mechanism for recording and analyzing your data. Once your system is set-up, you need to stay disciplined. Your records need to be complete and up-to-date if they are going to be reliable. Information from your records will help you avoid potentially deadly mistakes like spending too much, setting prices too high or too low, or paying too much or too little in taxes.

Accounting Systems

What type of system is best for your business? Before you spend any money on your business start-up, set up a record system suitable for the business. Your records system provides the framework for your bookkeeping activities. You may want to consult an accountant to assist you setting up your system if you are not familiar with business records and bookkeeping procedures.

As soon as you start thinking about records, you need to decide if you want to keep your records on paper or use a computerized system. Depending on your level of computer skills, your record keeping experience, and the nature of your business, a computerized system may or may not be the best choice.

If your business is very small or you're not accustomed to using computers, it might be best to keep your records by hand for a while. Most business supply stores offer a selection of record books at reasonable prices. Decide what type of records you want to keep and then select the record books to do so.

If you are used to operating a computer and have access to one, your best bet may be to use one of the relatively inexpensive business software packages on the market to keep your records. The software is typically easy to learn and most will include features like check-writing capabilities and report generating. Some of the more popular systems include QuickBooks® and Peachtree®. Both are readily available at office supply and discount centers, as are many others.

If your business will be large or complex and you can afford to do so, you might want to look into buying or leasing a computer even if you are not very computer-literate. Trying to manage a large number of transactions by hand can be overwhelming. Depending on the industry you are in, there might be specialized accounting systems tailored specifically for your business. Trade organizations and magazines are an excellent resource in selecting a software program. You might also consider talking to others within the industry to see what is or is not working for them.

No matter what type of accounting system you select, you will need to invest some time in setting it up and learning how to use it. The more you use the system, the more efficient you will become. This will allow you to have more time for what you really want to do...run your new business.

While this may also seem a bit overwhelming to you, remember that your accounting professional is there to help. He or she can help you design an accounting system and then provide you with training.

Cash vs. Accrual Accounting

What's next? Once you have selected your accounting system, whether it is manual or automated, you need to decide how you are going to keep your records. There are two basic accounting methods available to most small businesses – cash or accrual. In some cases, you may be able to use a hybrid method that combines elements of both cash and accrual reporting.

The major difference between cash and accrual is that a cash-method taxpayer recognizes income and expenses at the point in time that money is actually received or paid. In contrast, an accrual-method taxpayer generally reports income when earned and expenses as they become due.

As you would guess, the cash method is simple to use because income is reported when you receive the money from customers, and an expense occurs when you pay for it. The accrual method is a bit more complicated because you must recognize income when you earn it (using accounts receivable to keep track of what customers owe you) and expenses when you receive the goods or services (using accounts payable to keep track of what money you owe to others).

You will want to consult your accounting professional as to which method of accounting is best for your business since the Internal Revenue Service has different requirements for some business forms and types.

Chart of Accounts

Once you have selected an accounting system and accounting method, the next step is to set up a chart of accounts. Your chart of accounts is a listing of all your asset, liability, equity, revenue, and expense categories.

In simple terms,

- Assets are anything you own or have rights to.
- Liabilities are what you owe.
- Equity is the difference between your assets and liabilities.
- Revenue are income generators.
- Expenses are income reducers.

When creating your chart of accounts, you can be as detailed and specific as you want to be. For example, you might want to have separate expense accounts for gas, electric, and water expenses or you might just want to lump them all together in an utilities expense account. Your accounts will be used to generate reports, so you should create accounts for all the different categories you want to track.

Illustrative Chart of Accounts

Below is the chart of accounts for Bea's Book Shop, a fictional company used throughout this material. As you can see, the owners created a simple chart of accounts to track receipts and expenditures.

Bea's Book Shop Chart of Accounts

Assets

- Cash
- Accounts Receivable
- Inventory
- Capital Assets (equipment, furniture, vehicles, building, land, etc.)
- Accumulated Depreciation

Liabilities

- Accounts Payable
- Payroll Taxes Payable
- Loans Payable

Equity

- Owner's Equity
- Owner's Contributions
- Owner's Draw

Revenue

- Sales and Receipts

Expenses

- Advertising
- Bank Service Charges
- Cost of Goods Sold
- Credit Card Fees
- Depreciation
- Health Insurance
- Insurance
- Interest
- Miscellaneous
- Office
- Payroll
- Payroll Taxes
- Professional Fees
- Rent
- Subscriptions and Dues
- Supplies
- Taxes and Licenses
- Utilities and Telephone

Recording the Transactions

Then what? Once you have created a chart of accounts, you are ready to begin recording transactions. Keep in mind that you should record all transactions relating to your business, including the initial start-up costs. Since most of your transactions will involve cash, it's easier to think of them like entries in a check register. You usually record the date, who it was to or from, and the amount. There's also usually a spot for a memo. It's that memo that's the key to the bookkeeping system. In your memo, you write down what the cash disbursement or cash receipt was for. Now, all you have to do is associate an item from your chart of accounts with it. For example, if you write a check to the gas company, then your memo is for gas or utilities. If you deposit money from your customers in your bank account, then the memo would be sales. How you actually record your transactions depends on the type of system you selected, but all of them will rely on the memo account you select.

When trying to decide which account you want to use in your memo, it is important to know just what the inflow or outflow is for. Receipts are all monies from all sources and increase cash flow. Income is generated by business activities from labor, sales, and services. Income is used to determine the bottom line. You might be thinking that these two terms sound synonymous, but they are different. For example, say you borrowed money from a bank and deposited it into your checking account. The deposit would be a cash receipt, but would not be income since you have to pay it back. If the deposit was for fees you charged a customer, then it would be considered income.

The same is true from expenditures and expenses. Expenditures are all payments for all purposes and decrease cash flow. Expenses are some payments for certain purposes used to determine the bottom line. As an example, let's say you wrote a check to a car dealer for your new delivery van. The check would be a cash expenditure, but it would not be an expense since you purchased an asset. If that check was to repay your loan to the bank, it would also be an expenditure, but not an expense. You are paying back a liability. Now, if that check was to the gas company for last month's utility bill, then the cash expenditure would be an expense.

You can see just how important it is to correctly select the account from your chart of accounts. All the reports generated are based on how you classify your receipts and expenditures. In order to get a true picture of how your business is doing, all the transactions must be classified correctly.

Internal Controls

Another key to running a successful business is to have strong internal controls in place. The branches of the government are designed to provide a system of checks and balances. The same should be true for your business and records systems. Your system should be designed to ensure that all transactions are correctly recorded. Probably one of the most common tools for this, especially for small businesses, is to reconcile your bank account. By comparing your records with that of the bank, you will be able to find unrecorded or improperly recorded cash transactions.

Along the same lines are fraud prevention and detection. Checks and balances should be built into your system to protect you against this. You will want to review invoices and statements to

make sure they are for goods or services you actually received or used. You will also want to authorize all expenditures and purchases. It's also a good idea to have one person be in charge of the assets and have another do the record keeping for them (if at all possible). Periodically compare what is recorded to what is actually there. This will help to detect theft or misuse of assets. Be especially cautious with cash accounts and small items. These can too easily be stolen. You want your records to reflect an accurate picture of your business. If transactions are not properly recorded, then your reports can't be accurate.

CHAPTER 4: PAYROLL AND MISCELLANEOUS TAXES

At some point in your business's life, you may decide to pay wages. With employees comes a whole new set of responsibilities and liabilities known as payroll taxes.

Payroll Taxes

Take a moment to think back to the day you received your very first real paycheck. You may remember experiencing some shock upon noticing that the check amount was much less than your actual wages. A quick glance of the pay stub alerted you to the fact that your employer had reduced your pay by a number of deductions, the most significant of which were the amounts for federal and state taxes. As you are now aware, your employer was withholding from your check the various taxes you, as a wage earner, had to pay.

Once you become an employer, you, too, will have to withhold taxes from the employees' pay and deposit the amounts with the appropriate taxing agencies. Furthermore, as the employer, you yourself will have to pay certain taxes based on what you pay your employees.

Together, those taxes that you are required to withhold and those you directly pay are known as your payroll taxes. They may include federal withholding, state withholding, Medicare tax, Social Security tax, federal unemployment tax, and state unemployment tax. Together, Medicare and Social Security taxes are known as FICA tax.

The IRS provides you with a guide to payroll and payroll taxes in the Internal Revenue Service Circular E. It is highly recommended that you request this guide as soon as you start thinking about paying wages. An excellent resource, it will walk you through all the payroll topics discussed in this chapter and will also provide you with the current payroll tax withholding tables. The Nebraska Department of Revenue publishes an equivalent guide known as the Circular E-N.

An Eight-Step Approach

The key to controlling your payroll tax obligations is making all payments when due. If you don't, you are bound to get hit with some very costly penalties. The following eight-step approach to payroll tax compliance will help you to avoid such penalties.

1. *File for employer identification numbers.* As discussed in chapter 2, you need to file for federal and state identification numbers. These numbers are used when reporting federal income tax withholding, FICA taxes, and state withholding taxes. You may also be required to report federal and state unemployment taxes. Your federal ID number can be used for the federal unemployment tax, but a separate account number is required for state unemployment tax. Typically, you will file for a state unemployment number as soon as you start paying wages if this is a tax you are subject to. When you file for your federal ID number, you should receive a book of federal tax deposit coupons. These coupons will be used when paying most federal taxes, including payroll taxes. Alternatively, you may elect to transmit your tax payments electronically.

2. *Determine worker classification.* A worker can be either an employee or an independent contractor. While the business is liable for payroll taxes on amounts paid to an employee, there is no tax liability on amounts paid to independent contractors. The IRS provides us with guidelines to help determine if someone is an employee of the business or an independent contractor. You may also request that the IRS make this determination for you. To do so, you must file the Form SS-8 Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding. Once you have determined if a person is an employee of your business, you need to report him/her to the new hire division in your state (i.e. the Nebraska New Hire Division). Typically this involves relaying the information the employee provided you on the W-4 form. To learn about these reporting requirements, contact the new hire division.
3. *Determine covered employees.* Employees whose services are subject to payroll tax are known as covered employees. By statute, some special classes of employment are exempt or partially exempt from payroll taxes. Consult your accountant when determining which employees are subject to or exempt from payroll taxes.
4. *Determine taxable compensation.* The amount of employment taxes the employer should withhold and/or pay is calculated by multiplying the appropriate payroll tax rate by the amount of taxable compensation. Again, determining just what constitutes taxable compensation can be extremely complex. Some wages may not be subject to tax or there may be certain non-cash items that need to be taxed (such as personal use of a business vehicle or health insurance paid for shareholders owning more than 2% of a S-corp). Again, it is best to consult with your accountant. He or she can help you determine just what is or isn't taxable compensation.
5. *Withhold federal and state taxes.* After determining what amounts are subject to the different federal and state taxes, calculate the amount of tax to withhold by multiplying the tax rate by the taxable compensation. Computerized software programs are ideal for doing payroll. In many cases, just being able to correctly calculate payroll will more than pay for the cost of a computerized accounting program like QuickBooks®. You might also consider setting up a spreadsheet if you are not using a payroll program.

If you don't use such a program, then use the tables in the Circular E and Circular E-N to calculate the federal and state income tax to withhold. Next, you need to figure the Social Security and Medicare taxes. To do this, take the taxable wages times 1.45% (Medicare) and 6.20% (Social Security). Be advised that you only calculate Social Security taxes on the first \$87,900 of an employee's wages (for the year 2004). Once an employee has reached this wage base, you do not have to withhold Social Security tax.

As an employer, you are required to pay certain taxes on top of the amounts withheld from the employees' paychecks. The Social Security and Medicare taxes (FICA taxes) are known as matching taxes. In other words, you must match the amounts of those taxes withheld from the employees' checks.

You may also be subject to federal and state unemployment tax. These taxes are paid by the employer only and are not withheld from the employees' checks. Federal unemployment tax is paid on the first \$7,000 of an employee's wages. Once the employee has earned over \$7,000 for the year, tax is no longer required to be paid. The federal unemployment tax rate is 0.8%. State unemployment tax requirements vary state by state. In Nebraska, state unemployment tax must also be paid on the first \$7,000 of an employee's wages. The rate of the tax is determined by the Nebraska Unemployment Insurance department and may change year to year.

6. *Deposit employee and employer payroll taxes.* Employers accumulate four different types of federal payroll tax: withheld income tax, withheld FICA tax, employer-matched FICA tax, and federal unemployment tax. Employers also accumulate two types of state tax: withheld income tax and state unemployment tax.

Generally, withheld federal income tax, withheld FICA tax, and employer matched FICA tax must be deposited at your bank using one of the federal tax deposit coupons. Your federal unemployment taxes are usually required to be deposited once each quarter. If you wish, you can elect to electronically transmit your tax payments.

State income taxes withheld are not deposited at a bank, but are remitted directly to the Nebraska Department of Revenue. Typically, they are remitted monthly, quarterly, or sometimes annually, depending on how many dollars are withheld. State unemployment taxes are remitted to the Nebraska Unemployment Compensation Fund quarterly.

7. *File quarterly payroll tax returns.* The federal income tax withheld, the withheld FICA tax, and the employer-paid FICA tax are reported on a Form 941. This form must be filed quarterly. Agricultural employers report these taxes on a Form 943. However, this form is only filed annually. State withholding taxes are reported on a form 941N for all businesses, including agricultural. Federal unemployment taxes are annually reported on a form 940 or 940-EZ. Finally, state unemployment taxes are reported on Form UI 11T and 11W quarterly. Quarterly and annual payroll tax returns must be filed with the appropriate authorities by the last day of the month immediately following the end of the quarter or year. These forms are filed on the calendar-year basis regardless of your business's fiscal year.
8. *File W-2's and 1099's.* Annually, you are required to file information returns in addition to your normal quarterly payroll tax returns. A W-2 reports the wages and taxes withheld from employees. The 1099's are used to report other payments for items such as rent, payments to independent contractors, payments to attorneys, and interest payments. You should work with your accountant in preparing these forms. Items like pension plans and other fringe benefits have special reporting requirements and your accountant can make sure you are correctly reporting them.

Additions and Deductions

Before you worry about payroll taxes and tax returns, you need to decide just what and how you are going to pay your employees. Your payroll can be as simple as basic wages and salaries or it may also include various additions and deductions – both pre-tax and after-tax. Your employees might earn commissions or bonuses in addition to their regular wages. Maybe you reimburse employees for their business expenses.

Certain deductions can be subtracted from gross pay before calculating some federal and state tax. Not only do these deductions save the employee money (less tax withheld from their check), but they also save the employer payroll taxes (you'll remember that the employer must match dollar for dollar the FICA taxes withheld from the employee's paycheck). You'll want to check with your accountant to see what deductions qualify for pre-tax treatment. Other deductions do not qualify for pre-tax treatment and are deducted from the employee's check after the taxes are calculated. They are referred to as after-tax deductions. There are ways to change some after-tax deductions to pre-tax deductions with assistance from your accountant. For example, by adopting a cafeteria plan, employees can pay for group health insurance with pre-tax dollars instead of after-tax dollars.

Other issues complicating the payroll process include garnishments, wage assignments, child support withholding orders, and federal tax levies – paying part of an employee's net pay directly to a third party to satisfy a credit obligation. These payroll deductions are often imposed by federal and state agencies and bring with them their own complex rules and requirements. Unfortunately, in today's society, you are bound to run into these situations at some point during your business's life. The agency imposing the assessment should provide you with adequate information explaining the different requirements. If you are uncertain on any areas relating to the deduction, you should get clarification from the agency or speak with your professional advisor.

Penalties and Interest

And then there are the dreaded penalties. If there's one part of your business that you want to stay on top of, it's your payroll and payroll tax liabilities. The taxing agencies assess all types of penalties, but most center around the failure to file a required tax return, the failure to provide a payee a reporting statement, or the failure to pay tax when due. Your accountant can advise you on your specific reporting and depositing requirements. The penalties can be avoided if you correctly calculate your taxes, pay or deposit your taxes on time, and file the proper forms when required. Interest may also be assessed. Your Circular E and Circular E-N provide valuable information on your compliance requirements.

Employees are a vital part of any business, and the same is true for your payroll system. Don't let all the issues scare you away from hiring and paying employees. Really, once you get a system set up and work with it for a little while, dealing with payroll will become second nature. No matter what your skill level, you *can* successfully stay on top of your payroll responsibilities. Work with your accountant to develop a payroll system and also to understand your depositing and reporting requirements.

Miscellaneous Taxes

In addition to payroll taxes, businesses are also subject to miscellaneous taxes. It's a good idea to discuss with your accountant the various taxes you might be liable for.

Sales tax. If you sell goods or certain services, you more than likely must collect sales or excise taxes from your customers. The money you collect is then remitted to the taxing agency. As a business operator, you are simply a middleman. The money you collect is not income to you. It is a liability since you must pay it to another agency (typically the Nebraska Department of Revenue, who then distributes the monies to cities, counties, and the like). Many taxes are industry-specific, so be sure to check for any special requirements. For example, the hospitality industry collects lodging tax.

Real estate tax. If your business owns real estate, you will be liable for real estate taxes. Just like the tax on your personal residence, you will receive a statement from the county at the end of the year. The taxes are then due in two installments the next year. Since they are paid by your business, they are a deductible business expense.

Personal property tax. In Nebraska, personal property tax is assessed on business and farm property. Your initial property tax return is filed voluntarily with the county in which the property is located. Once your initial return is filed, you will receive preprinted forms annually. The returns are due by May 1st each year. Personal property taxes are also payable in two installments and are a business expense.

CHAPTER 5: SELECTING A YEAR-END

Upon the initial setup of your business you encounter many decisions, most of which affect your taxes. The selection of year-end affects how you determine your income and to some extent how you run your business. A business is generally considered to have “chosen” their year-end when they file their initial tax return. A common misconception among new business owners is that they can choose any month they wish. In theory this is true, but in reality there are many limitations.

Sole Proprietorships

Since sole proprietorships are not separate entities in the eyes of the IRS they must generally use the same tax year as that of their owner. Therefore, most sole proprietors use a December (calendar) year-end because most individuals began early in life filing personal tax returns on a calendar year basis. Any desire to change to a non-December (fiscal) year-end requires special permission from the IRS.

Partnership / Limited Liability Companies

Partnerships and limited liability companies must also use the same year-end as their owners. However, since there are more than one owner, one must use the same year-end as the “majority” of its owners.

S Corporations

Corporations that have elected to be treated as an “S” corporation must generally use a calendar year. An exception may be made if you can convince the IRS that a business purpose exists for using a different year-end.

C Corporations

Regular corporations have the ability to choose their year-end as long as the cycle chosen clearly matches revenue and expenses.

Establishing Your Year-End

A business is generally considered to have “chosen” their year-end when they file their initial tax return. However partnerships and S corporations that initially want to qualify for a tax year-end other than that which is “required” may elect to do so on Form 8716.

Changing the Year-End

If you want to change your year-end, you must get permission from the Internal Revenue Service. To get their permission you must satisfy them that there is a valid business reason and that it is not being done strictly for tax avoidance. IRS Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, must be filed to request approval.

CHAPTER 6: INCOME TAXES

Income Tax Forms

All businesses except partnerships and limited liability companies must file annual income tax returns. Partnerships and LLCs file annual information returns. Which form you use depends on how your business is organized. Entity types require the following annual forms on which their respective profit or loss is reported.

Entity type	Form required	Due Date	Extensions
Sole Proprietor	1040, with Schedule C or F	to Aug. 15 and Oct. 15	To Aug 15 and Oct 15
Partnership	1065	April 15	To July 15 and Oct 15
S Corporation	1120S	2 ½ months after year-end	Additional 6 months
C Corporation	1120	2 ½ months after year-end	Additional 6 months
LLC	1065, if taxed as partnership	April 15	To July 15 and Oct 15

Estimates

Corporations owing \$500 or more and individuals owing \$1,000 or more must remit estimated income tax payments or be subject to penalties. Generally, taxable entities must have at least 100% of their prior year's tax paid in to avoid underpayment penalties. In a taxpayer's first year of business or if no return was filed for the prior year, 100% of the current year tax is used. The required annual payment is broken down into 4 quarterly payments.

Corporate estimate payments are due on the 15th day of the fourth, sixth, ninth, and twelfth months (i.e. Apr 15, Jne 15, Spt 15, & Dec 15 for a calendar year) and are made in the same manner as your Federal payroll tax deposits.

Individual estimate payments are due by Apr. 15, June 15, Sept. 15, and Jan. 15 and are made via Form 1040-ES.

Tax Planning

Tax planning involves looking at a variety of options in an attempt to eliminate or reduce one's income tax obligation. There can be options when it comes to handling most business transactions. It is important to recognize that there is nothing wrong with tax avoidance, as it is everyone's right to pay in the lowest **legal** tax liability. However tax evasion, which involves some fraudulent intent, is illegal.

Some areas considered as fraudulent include 1) failing to report large amounts of income, 2) claiming fictitious deductions, 3) failing to keep adequate records, and 4) improperly allocating income to related taxpayers who are in a lower tax bracket.

Strategies involved in tax planning can focus either strictly on the business or the owner's individual situation, but many times include both. The focus becomes structuring transactions to accomplish one or more of the following:

1. Reduce the amount of taxable income
2. Reduce the tax rate
3. Control the time when the tax is paid
4. Assuring that all available tax credits are claimed
5. Managing other tax obligations

Effective planning necessitates that you look forward and try to estimate your income over the upcoming years. While this seems difficult without a crystal ball you are, or should be, already doing something similar when you budget for cash flow purposes. An important thing to remember is that the better your estimates are, the better the chances that your tax planning is successful.

State Taxes

The above information has primarily focused on federal taxes. One must remember that, generally, there are filing requirements in the state(s) in which you do business. State taxes generally follow the federal rules although some items are treated differently, and there are probably no two states that calculate income and the related tax the same.

State tax rates vary from approximately 4% to 10% depending on the state. If you do business in more than one state, your income is apportioned between those states and tax is paid to each state based on their share of the income.

Conclusion

No one looks forward to filing an income tax return, whether they be a business or an individual. What you need to bear in mind is that this is just a requirement of doing business and keeping accurate records is more than half the battle.

CHAPTER 7: CASH PLANNING AND FORECASTING

Before you pump your life savings into your business venture or borrow more money than you ever imagined, you want/need to know if your dream can succeed. Think of it as a “look before you leap” attitude. One must determine if the prospective business can generate sufficient cash flow. In its simplest form, cash flow is the movement of money in and out of your business.

As a business owner it is necessary to project your cash flow not only from a management prospective, but from a financing perspective. Most, if not all, financial institutions will ask you to show them a forecast of your business for each month of the next year and probably annually for a five year period.

Many times it is advisable to prepare a cash flow budget which is also known as a forecast. A cash flow budget projects your business’ cash inflows and outflows over a period of time. Many times this is prepared on a monthly basis but can be modified to a weekly or daily basis. The main reason for preparing a forecast is to predict your business’ ability to take in more cash than it pays out. It can assist you in determining when/if you will have gaps in your cash flow, which in turn will allow you to attempt some corrective steps.

A Four-Step Approach

Preparing a forecast or cash flow budget involves four steps:

1. preparing a sales forecast
2. projecting the anticipated cash inflows
3. projecting the anticipated cash outflows
4. calculating your bottom line by putting the projections together

The sales forecast is actually an estimate of what you expect your sales to be. An existing business has the luxury of looking back at the previous year and forecasting its sales based on history. This is a difficult step for a new business with no financial history and demonstrates the importance of doing a market feasibility study or the like to gauge the sales.

Inflows are money moving into your business. Inflows could be from sales generated with your customers as well as proceeds from bank loans.

Outflows are money moving out of your business and generally result from the payment of expenses. However paying back loans and purchasing equipment are also considered outflows.

The following is substantially more simplified than real life but illustrates the concept.

<i>Beginning Cash Balance</i>
+ Projected Cash Inflows
- Projected Cash Outflows
= <i>Your Cash Flow Bottom Line (the ending cash balance)</i>

On the next page is an illustration of an actual cash flow statement for a six-month period.

An important thing to remember is that profit is NOT the same thing as cash flow. It is possible to show a profit for the year yet face cash flow difficulties.

Following is an illustration showing the differences.

<i>Bea's Book Shop</i> <i>Comparative Balance Sheets</i>		
	<i>12/31/02</i>	<i>12/31/03</i>
Cash	\$18,000	\$6,100
Accounts Receivable	12,000	27,000
Inventory	6,000	9,000
Property and Equipment	83,000	83,000
Less: Accumulated Depreciation	(45,000)	(49,000)
<i>Total Assets</i>	<i>\$74,000</i>	<i>\$76,000</i>
Accounts Payable	\$7,000	\$7,600
Notes Payable (Bank Loans)	27,500	12,000
<i>Total Liabilities</i>	<i>\$34,500</i>	<i>\$19,600</i>
Stockholder's Equity	\$39,500	\$56,500
Total Liabilities and Equity	\$74,000	\$76,000

<i>Bea's Book Shop</i> <i>Income Statement</i> <i>December 31, 2003</i>	
Sales	\$268,000
Less: Cost of Goods Sold	132,000
Gross Profit	\$136,000
Less: Operating Expenses	(115,000)
Less: Depreciation	(4,000)
Net Profit	\$17,000

Bea's Book Shop will have to adjust its accrual net profit to determine its cash flow for the year. As a general rule, you can convert your accrual net profit using the following formula:

<i>Net Profit</i>
+ Depreciation
- Increases (or + Decreases) in Accounts Receivable
- Increases (or + Decreases) in Inventories
+ Increases (or - Decreases) in Accounts Payable
- Decreases (or + Increases) in Notes Payable (Bank Loans)
= <i>Net Cash Flow</i>

Using the formula above, Bea's can adjust its accrual net profit to determine its cash flow for the year:

<i>Adjustment Description</i>		<i>Amount</i>
Net Profit--December 31, 2003		\$17,000
Add:	Depreciation	4,000
Subtract:	Increase in Accounts Receivable between 12/31/02 and 12/31/03	(15,000)
Subtract:	Increase in Inventory between 12/31/02 and 12/31/03	(3,000)
Add:	Increase in Accounts Payable between 12/31/02 and 12/31/03	600
Subtract:	Decrease in Notes Payable between 12/31/02 and 12/31/03	(15,500)
Net cash flow for the year ended December 31, 2003		(\$11,900)

Bea's Book Shop's accrual net profit and the net cash flow for the year ended December 31, 2003 report two entirely different results. The income statement prepared using the accrual method of accounting reports a profit of \$17,000 for the year. However, in terms of a cash flow, Bea's had a negative cash flow of \$11,900 for the same year. In other words, Bea's spent \$11,900 more than it collected during the year.

CHAPTER 8: OBTAINING CREDIT AND FINANCING FOR YOUR BUSINESS

Financing your business, whether in the start-up or growth phase, may be one of your biggest challenges. You may not have sufficient personal monies and those that have the resources may not be willing to lend them to you. It is important to try to avoid getting in the position to “take whatever you can get” because in the long run this can be very costly.

How Do I Get the Money

Two words **à** be prepared!

Preparing a realistic projection of the funding necessary will force you to consider all the costs involved and assist you in being prepared to convince a potential investor or lending institution that you understand your business venture. You should expect an investor or lender to want to know how much money you will need from the beginning through establishment of the business, how the money will be used, and most importantly, how you will repay the money or how it will result in a profit. All of this information should be included in a business plan and be accounted for in your cash flow budget or forecast. Embellishing your projections with statistical industry information, such as is found in Dun & Bradstreet, can be wonderful supporting information.

Financing Alternatives

Unless you are personally wealthy or a recent lottery winner, you must become familiar with the sources of financing available.

Personal funds – Most start-up businesses are initially funded with the entrepreneur’s personal assets. These assets may include your personal savings, cashing in a retirement plan, or funds borrowed personally from a lending institution. Many times an individual’s personal assets are, or can be, used as collateral to secure a loan and often times a personal residence is used. You can obtain a first or second mortgage, refinance an existing mortgage, or borrow on a home equity line. Unfortunately, this alternative can be costly, either through higher interest rates or in the occurrence of a default on the loan and loss of your home.

Borrowing from yourself should be carefully documented through notes and written documentation similar to that you would have with an unrelated lender. Any time you lend to your business, you should evaluate the transaction with the risks involved and be comfortable with those risks. Be sure to balance your enthusiasm for your business with a realistic assessment of the consequences of partial or complete loss of your investment.

Family, friends, and associates – The second most common place to find start-up funding is from one of these individuals. Borrowing from them is attractive because of the informality and privacy issues. Caution should be exercised however because misunderstandings can unfortunately arise and compromise both the business and personal relationships you have.

Lending institutions – This category includes not only banks but credit unions, franchise companies, the Small Business Administration, etc. Generally speaking a well-defined business plan and forecast are your best bets if pursuing these venues.

Sources of Debt Financing

When we discussed “borrowing” funds above, whether it be from a friend or a lending institution, that is considered debt financing. Debt financing is funds that will be repaid over a period of time, generally with interest. Debt financing can be short-term (less than one year) or long-term (repayment occurs over a multi-year period). The creditor doesn’t obtain an ownership interest and is attractive for that very reason. In addition, the interest payable on the loan is a deductible business expense and the recurring payment is a fixed expense for budgeting purposes.

Some items to consider as you look at your options include:

- What are the costs of the loan (interest, closing fees, etc.)?
- Are there any monetary and compliance issues?
- Do you have documented credit history, collateral, cash flow, etc.?
- Can suppliers be used to circumvent conventional borrowing?

Sources of Equity Financing

Equity financing involves the exchange of money for a share of ownership in the business. Equity financing to some is unacceptable because they are unwilling to share control of their business with someone else and requires you to sacrifice some of your autonomy. An advantage to this method of financing is having access to an investor’s expertise and advice while maintaining a relationship with someone, whom you trust, to possibly sell your business to at a sizable profit at a later date.

Following is a table of some of the funding sources for a start-up business.

Primary Sources	
<i>Long-term financing</i>	<i>Short-term financing</i>
<ul style="list-style-type: none"> n Personal financing n Insider (family/friends) financing n Angels n Equity financing n Leasing n Credit unions n SBA LowDoc 	<ul style="list-style-type: none"> n Personal financing n Insider financing n Credit cards n Credit unions n Trade credit n Banks n SBA Microloans n SBA LowDoc
Secondary Sources	
<i>Long-term financing</i>	<i>Short-term financing</i>
<ul style="list-style-type: none"> n Business alliances n SBA regular 7(a) program n Venture capital n SBICs n State and local public financing n Franchising n Asset-based financing 	<ul style="list-style-type: none"> n SBA CAPLines n Consumer finance companies n Commercial finance companies n State and local public financing

CHAPTER 9: INSURANCE

As a businessperson, if you cannot afford insurance, you cannot afford to be in business. With all the time and money you invest in your new business, it would be a shame to lose it all if the unforeseen happens. You can have too little insurance or too much insurance, but you must have insurance. Like many things relating to being in business, this is a technical and complicated area. Therefore, it is necessary to enlist the assistance of good insurance advisors. They can tell you what insurance you should have, how much you need, and see that you don't overpay for it. You should meet with your insurance agency at least annually to review your coverage.

Types of Coverage

There are four basic kinds of insurance that you as a business owner will want to look into:

1. *Property*. Property insurance covers your property from various types of losses such as fire and theft. Protection can also be obtained for windstorms, hail, riots, explosions, and the like. This is known as extended coverage. Property includes such things as buildings, machines, furniture, inventory, etc.
2. *Liability*. Liability insurance covers you against losses caused by your own carelessness or negligence. Even though you are careful, under the law you may have not been as careful as you should have. The amount of a damage claim can be huge.
3. *Motor vehicle*. Motor vehicle insurance typically includes a combination of property and liability insurance. There are many kinds and types of policies, such as those for owned and non-owned automobiles.
4. *Special types*. All other insurance can be lumped into this catch-all category and might include:
 - a. Workers' compensation insurance
 - b. Life insurance
 - c. Health or medical insurance
 - d. Disability insurance
 - e. Business interruption insurance
 - f. Malpractice insurance

Fairly new to the insurance industry are comprehensive or package policies. Instead of having separate policies for each type of coverage, all your insurance needs are written into one or two policies. The cost is usually less than when it is bought separately. Also available are umbrella policies which provide added coverage at a lesser rate for amounts in excess of the first policy.

Insurance should be purchased before you start your business. It is not something you "wait until later" to buy. Visit with an insurance agent to discuss the various options available to you. Typically, agents do not charge you for their advice, and they can work up premium quotes for several different types and levels of coverage. It might also make good business sense to shop around for coverage. Be warned that if you do this, you need to compare apples to apples, not apples to oranges. Have the various agencies work up quotes based on identical or nearly identical coverage and deductibles.

CHAPTER 10: SELECTING PROFESSIONAL ADVISORS

The term professional advisor can include individuals from the accounting, legal, insurance, and financial arenas. You, as a business owner, must be comfortable with each individual and/or firm that you select. A good place to begin your search is to ask friends, neighbors, or other business associates. Many times personality plays a big role in a person's comfort level, so it is important to consider only the advice from those sources you feel have similar personalities to yours or that you respect.

Particularly in the accounting and legal areas comfortable communication is necessary. The goal of these individuals is to advise you, whether through tax planning, financial planning, or in other areas. In order to do this well, you must feel comfortable enough with these advisors to share virtually everything about yourself. Just about everything occurring in your life, from a child about to enter college to marital problems to the possibility of a large inheritance, bears an impact on the advice given.

It may be helpful to personally visit several advisors to determine those that you are comfortable with. Most professionals are more than willing to meet with prospective clients, which you should use to your advantage.