27 Starting a Business, Schedule M-1/M-3

Tab 27 Contents

Websites

www.archive.org	Internet Archive Wayback Machine
www.bizstats.com	Business/Industry Statistics
www.bls.gov	U.S. Bureau of Labor Statistics
www.copyright.gov	U.S. Copyright Office
www.franchise.org	International Franchise Association
www.sba.gov	Small Business Administration
www.score.org	SCORE/Business Mentors
www.usa.gov/business	Small Business Resources
www.uspto.gov	U.S. Patent and Trademark Office

Starting a Business Checklist

Skip any item which does not apply to the business. ✓ *Done*

1) Develop a business concept ________
2) Select and retain accountants and attorneys ________
3) Select a business entity ________
4) Determine ownership structure ________
5) Complete a business plan including marketing, finance, management, and operational sections ________
6) Obtain initial start-up capital ________
7) File for organization with state ________
8) Hold first board of directors meeting ________
9) Apply for a federal employer identification number (EIN) by submitting Form SS-4 ________
10) Apply for S corporation status by filing Form 2553, if desired ________
11) Develop website and a plan for use of technology including cyber security ________
12) Establish accounting procedures and choose accounting software or a third-party bookkeeping and accounting company ________
13) Input all transactions from the beginning of business development into accounting software ________
14) Apply for business financing and solicit investors ________
15) Open business bank accounts ________
16) Apply for required permits or licenses ________
17) Select an insurance agent ________
18) Purchase insurance ________
19) Select a commercial real estate agent ________
20) Locate and obtain office or production space ________
21) Acquire furniture and equipment ________
22) Complete any needed build-out of space ________
23) Select a payroll processing company ________
24) Select an employee benefits company ________
25) Hire staff and complete training ________
26) Commence marketing ________
27) Order initial inventory and begin production ________
28) Conduct a grand opening ________

Equal Employment Opportunity Laws

Equal Pay Act (1963)	Requires men and women to be paid equally for substantially similar work.
Civil Rights Act (1964)	Prohibits employment discrimination based on race, color, sex, religion, or national origin.
Age Discrimination in Employment Act (1967)	Protects individuals over age 40 from age-based employment discrimination.
Americans with Disabilities Act (1990)	Prohibits employment discrimination against individuals with disabilities.
Genetic Information Nondiscrimination Act (2008)	Prohibits employment discrimination based on genetic information.

Business Entity Attributes Chart

	Sole Proprietorship	Single-Member LLC	Multimember LLC	General Partnership	Limited Liability Partnership	C Corporation	S Corporation
Formation	No formal creation process.	Simple creation process.	Simple creation process. Operating agreement advisable.	Simple creation process. Partnership agreement advisable.	Simple creation process. Partnership agreement advisable.	May be complex and expensive to create and maintain.	May be complex and expensive to create and maintain.
Operation/ Dissolution	Easy to operate and dissolve. Business owned by spouses may be eligible to file as qualified joint venture.	Easy to operate and dissolve. LLC laws vary by state. Failure to follow statutory requirements can result in loss of LLC status.	Separate entity from members. Flexibility in operations. Failure to follow statutory requirements can result in loss of LLC status.	Separate entity from partners. Flexible allocation of profit, loss, and distributions.	Separate entity from partners. Flexible allocation of profit, loss, and distributions.	Separate entity from shareholders. Regular board of directors' meetings and minutes. More recordkeeping.	Separate entity from shareholders. Pro rata allocation based on ownership is required. Regular board of directors' meetings and minutes. More recordkeeping.
Sale	Transfer of ownership through sale of assets can be complex.	Transfer of ownership can be complex.	Membership interest can be transferred.	May be difficult to change/dissolve ownership.	May be difficult to change/dissolve ownership.	Ownership transferred through sale of stock.	Ownership transferred through sale of stock.
Liability	No liability protection except through insurance.	Limited liability protection. Business insurance advisable.	Limited liability protection. Business insurance advisable.	Unlimited liability for all partners.	Limited liability protection for limited partners if at least one general partner with unlimited liability.	No liability protection for non-active shareholders.	Liability protection similar to that of C corporation.
Tax return	No separate tax return.	No separate tax return.	Separate tax return.	Separate tax return. Basis must be tracked.	Separate tax return. Basis must be tracked.	Separate tax return.	Separate tax return. Basis must be tracked.
Self-employment taxation	On entire net profit of the business.	On entire net profit of the business.	On entire net profit from the business.	On partner's share of income.	On partner's guaranteed payments.	None.	Not assessed on the entire net profit.
Double taxation of profits	No.	No.	No.	No.	No.	Yes.	No.
Financing	Owner cannot raise equity financing.	Loan repayment guarantees may be required.	Loan repayment guarantees may be required.	Loan repayment guarantees may be required.	Loan repayment guarantees may be required.	Equity financing through sale of stock.	Equity financing by increase in number of shareholders.
Fringe benefits	Limited access to fringe benefits for owners.	Limited access to fringe benefits for owners.	Limited access to fringe benefits for owners.	Limited access and certain fringe benefits treated as guaranteed payment to partner.	Limited access and certain fringe benefits treated as guaranteed payment to partner.	Fringe benefit deduction for owner-officers.	Limited deductibility for owner-employees.
Likely businesses	Seasonal or part-time businesses. Businesses with little liability. Home-based businesses. Businesses intended to operate for the owner's life only.	Businesses with potential liability in operations. Businesses intended to operate for the owner's life only.	Businesses requiring equity capital. Businesses with potential liability in operations. Businesses intended to exist beyond the lives of the members. Businesses expecting changes in ownership over time	Two established businesses who wish to work as one. Partners wishing to consolidate multiple entities into one entity.	Businesses with partners not actively involved in business. Businesses with equity capital needs. Businesses with exposure to liability.	Businesses with ownership in multiple other entities. Businesses with significant exposure to liability. Businesses intended to exist eternally. Businesses that wish to provide tax-free fringe benefits to owner-employees.	Businesses with significant exposure to liability.

Business Entity Comparison Chart

Entity	Organization and Ownership	Taxation of Profits and Losses
Sole proprietor, single-member LLC, and spouses-owned business (See *Sole Proprietorships and Farmers,* Tab 5) • Schedule C (Form 1040), *Profit or Loss From Business* • Schedule F (Form 1040), *Profit or Loss From Farming* • IRS Pub. 225, *Farmer's Tax Guide* • IRS Pub. 334, *Tax Guide for Small Business*	• One individual carrying on an unincorporated trade or business. • A qualified joint venture whose only members are spouses may elect not to be taxed as a partnership and file as two sole proprietorships. An LLC may not make this election. See *Spousal business—qualified joint venture,* page 5-6. • Easiest business to organize with minimal legal restrictions. • The entity does not exist apart from the owner. Business starts and ends based on engaging in and ending engagement in business. • The owner has complete freedom over business decisions and is entitled to 100% of the profits. The owner is limited by his or her own ability to raise capital and obtain financing. Outside investors cannot be part owners. • Transfer of ownership consists of selling the business assets. • A single-member LLC is taxed as a sole proprietorship unless the election is made to be taxed as a corporation.	• The owner is self-employed and pays self-employment (SE) tax on net profits.* • Net profits are subject to income tax in the year earned and cannot be deferred by retaining profits. • Losses offset other income in year incurred, such as Form W-2 wages, interest, dividends, and capital gains. ***Exceptions:*** Losses cannot be used to offset income from activities subject to passive loss, at-risk loss, and hobby loss rules. • Owner may qualify for 20% qualified business income deduction (QBID).
Partnership (See *Partnerships and LLCs,* Tab 20) • Form 1065, *U.S. Return of Partnership Income* • IRS Pub. 541, *Partnerships* • IRS Pub. 3402, *Taxation of Limited Liability Companies* • IRC Subchapter K, §701 through §761	• Two or more owners conducting an unincorporated trade or business. • Easy to organize with minimal legal restrictions. • Multimember LLCs are taxed as partnerships, unless the election to be taxed as a corporation is made. • No limitations on the number of partners or partner entities. • More flexibility than a corporation in dividing up profits, losses, ownership of capital, and making special allocations to partners. • Contributing property in exchange for a partnership interest is generally a tax-free event. • Liquidating a partnership interest in exchange for property is generally tax-free, unless the liquidation is in cash only. • Getting out of a partnership may be more complicated than starting one. A partnership agreement can restrict selling or transferring of a partnership interest. • State law may limit an LLC's life.	• The partnership pays no income tax. Profits pass through to partners for individual payment of tax. • Tax to partners cannot be deferred by retaining business earnings. • Pass-through items retain the same character to the partner as they had to the partnership. • A general partner's distributive share of profits is subject to SE tax. Limited partners' share of profits not subject to SE tax unless in the form of guaranteed payments.* • Payment for partner services to the partnership is not Form W-2 income, but may be guaranteed payments, profits, or special allocations. • Losses flow through to partners and can be used to offset other income such as Form W-2 wages, interest, dividends, and capital gains. ***Exceptions:*** Losses cannot be used to offset income from activities subject to passive loss, at-risk loss, and hobby loss rules. • An LLC with at least two members is classified as a partnership unless it files Form 8832, *Entity Classification Election,* and affirmatively elects to be treated as a corporation. • Partner may qualify for 20% qualified business income deduction (QBID).
S corporation (See *S Corporations,* Tab 19) • Form 1120-S, *U.S. Income Tax Return for an S Corporation* • IRC Subchapter S, §1361 through §1379	• A corporation that has elected to be taxed as an S corporation by filing Form 2553, *Election by a Small Business Corporation.* • Ownership is through owning shares of stock. Limited to 100 shareholders. (Spouses and their estates and all members of a family and their estates, as defined in IRC section 1361(c)(1)(B), can be treated as one shareholder for this test.) • Stock is limited to one class of stock with equal rights to distributions and liquidation proceeds. • Shareholders are limited to individuals, estates, certain trusts, and certain charities. Corporations and certain partnerships are ineligible to own stock. See *S Corporation Qualifications,* page 19-3, for exceptions. • Other ownership and organization issues are the same as a C corporation.	• An S corporation generally pays no tax. Profits flow through to the shareholders. • Pass-through items retain the same character to the shareholder as they had to the corporation. • Distributions are not subject to self-employment (SE) tax. • Shareholders who perform services are paid as employees and income is reported on a Form W-2. • Losses flow through to shareholders and may be used to offset other income, subject to passive, at-risk, and hobby loss exception rules. • Shareholder may qualify for 20% qualified business income deduction (QBID).
C corporation (See *C Corporations,* Tab 18) • Form 1120, *U.S. Corporation Income Tax Return* • IRS Pub. 542, *Corporations* • IRC Subchapter C, §301 through §385	• A legal association carrying on a trade or business organized under state law. • Ownership is through owning shares of stock, and there is no limit on number of shareholders, or type of taxpayer or entity. • Forming a corporation may require complex and expensive legal procedures. Corporations must hold board meetings, shareholder meetings, and keep corporate minutes. Corporations are subject to federal and state regulations. • The life of a corporation is perpetual. Transfers of ownership can be as easy as selling or inheriting stock. • Liquidating a corporation is usually a taxable event, and contributions in exchange for stock may be taxable. • Raising additional capital can be as easy as issuing new shares of stock.	• Shareholders who perform services are paid as Form W-2 employees subject to payroll taxes and reporting rules. • Reasonable wages must be paid and not inflated to reduce corporate tax liability. • Net profits are subject to tax at the corporate 21% rate. Profits distributed as dividends are taxed again on the shareholder's tax return. Tax to the shareholders can be deferred by retaining earnings for business purposes. • Losses do not pass through to shareholders. Business losses must be carried over to a year with profits. Capital losses must be carried over to a year with capital gains. At-risk limitations, hobby loss, and passive loss rules do not apply.

* For 2022, the maximum self-employment earnings subject to Social Security tax is $147,000. There is no limit on self-employment earnings for the Medicare tax. For details including the additional Medicare tax on self-employment earnings, see *Self-Employment Tax,* page 5-24.

continued on next page

Entity	Accounting and Recordkeeping	Fringe Benefits	Liability
Sole proprietor, single-member LLC, and spouses-owned business (See *Sole Proprietorships and Farmers,* Tab 5 • Schedule C (Form 1040), *Profit or Loss From Business* • Schedule F (Form 1040), *Profit or Loss From Farming* • IRS Pub. 225, *Farmer's Tax Guide* • IRS Pub. 334, *Tax Guide for Small Business*	• Accounting is less involved than partnerships and corporations. Double-entry bookkeeping is not required as no balance sheet is needed when filing Schedule C (Form 1040) or F (Form 1040). • A business owned solely by two spouses may elect not to be taxed as a partnership and may file as two sole proprietorships to minimize bookkeeping requirements. • Cannot file as a fiscal year business unless owner files Form 1040 under the fiscal year rules.	Excludable fringe benefits are generally not allowed for owner. ***Exceptions:*** Health insurance is deductible if spouse is an employee of the sole proprietorship, and the owner is covered as a family member of the employee-spouse. Owners are eligible for dependent care assistance fringe benefits, de minimis fringe benefits, and working condition fringe benefits.	Owner is personally liable for all debts and lawsuits against the business. ***Exception:*** If organized as an LLC under state law, liability is usually limited to owner's investment and his or her own malpractice or debt guarantees.
Partnership (See *Partnerships and LLCs,* Tab 20) • Form 1065, *U.S. Return of Partnership Income* • IRS Pub. 541, *Partnerships* • IRS Pub. 3402, *Taxation of Limited Liability Companies* • IRC Subchapter K, §701 through §761	• Small partnerships are not required to provide a balance sheet and can use the same bookkeeping system as a sole proprietor. Larger partnerships must provide a balance sheet with the return, which requires double-entry bookkeeping. • A partnership must generally use the same tax year as its partners, but can use a fiscal year if there is a business purpose or an IRC section 444 election was made. See *Election Other Than Required Taxable Year (IRC §444),* page 8-26. • Complex books and records are needed when a partner exchanges property, other than cash, for a partnership interest or for special allocations and basis elections.	Partners are eligible for some excludable fringe benefits. Taxable benefits are reported as guaranteed payments or an adjustment to a partner's distributable share of profits.	A general partner is personally liable for all debts and lawsuits brought against the partnership. ***Exception:*** If the partner is a limited partner, or the business is organized as an LLC under state law, liability is generally limited to the partner's investment, plus his or her own malpractice or debt guarantees.
S corporation (See *S Corporations,* Tab 19) • Form 1120-S, *U.S. Income Tax Return for an S Corporation* • IRC Subchapter S, §1361 through §1379	• Double-entry bookkeeping may be required depending on income and other factors affecting the need for a balance sheet on the return. • Must use a calendar year unless it establishes a business purpose for using a fiscal year, or it makes an IRC section 444 election. See *Election Other Than Required Taxable Year (IRC §444),* page 8-26.	Shareholder/employees are eligible for some excludable fringe benefits. Benefits added to taxable wages on Form W-2 of more than 2% shareholders include accident and health plans, up to $50,000 of group health insurance, and meals and lodging furnished for the employer's convenience.	A shareholder's liability is limited to the amount invested, plus his or her own malpractice or debt guarantees.
C corporation (See *C Corporations,* Tab 18) • Form 1120, *U.S. Corporation Income Tax Return* • IRS Pub. 542, *Corporations* • IRC Subchapter C, §301 through §385	• Double-entry bookkeeping may be required depending on income and other factors affecting the need for a balance sheet on the return. • No restriction on use of a fiscal year. ***Exception:*** A personal service corporation (PSC) must use a calendar year unless it establishes a business purpose for using a fiscal year or makes an IRC section 444 election. See *Election Other Than Required Taxable Year (IRC §444),* page 8-26. • Required to use accrual method of accounting if average annual gross receipts exceed $27 million.	Shareholder/employees eligible for excludable fringe benefits, generally to the same extent as any other employee, with exceptions under the nondiscrimination rules. Benefits can include health insurance and reimbursement, education, life insurance, etc.	A shareholder's liability is limited to the amount invested, plus his or her own malpractice or debt guarantees.

Entity Classification Elections (Form 8832)

Entity	*Default Filing*	*Check the Box Options*	*Cannot Be Taxed as:*
Individual	Sole proprietor, Sch. C (or Sch. E for rental)	Corporation	Partnership
Partnership	Partnership, Form 1065	Corporation	Sole proprietor
Corporation (formed as a corporation under state law)	C corporation, Form 1120; or S corporation, Form 1120-S (with S election)	N/A	Sole proprietor; Partnership
LLC (single-member)	Sole proprietor, Sch. C (or Sch. E for rental), or disregarded entity if owned by a corporation or partnership.	Corporation	Partnership
LLC (multiple-member)	Partnership, Form 1065	Corporation	Sole proprietor

Targeting a Business Plan to a Specific Audience

Audience or Objective	*Items to Emphasize*
Applying for Bank Financing	Sales Forecast, Forecasted Financial Statements, Breakeven Analysis, Personal Financial Statement(s), Managers and Key Employees.
Attracting Equity Investors	Products and Services, Marketing Plan, Operation Plan, Sales Forecasts, Managers and Key Employees.
Hobby-Loss Defense	Financial Plan, Operational Plan, Marketing Plan, Managers and Key Employees. See *Hobby Loss Rules,* page 5-21
Securing Vendors	Products and Services, Marketing Plan, Mission, Vision and Description, Managers and Key Employees.
Employees	Operating Budgets, Marketing and Sales Plans, Product Specifications, and Types of Services Provided.

Business Agreements

Incorporation agreements, partnership agreements, LLC agreements. Consult an attorney to ensure compliance with state laws when forming a business entity. See *State Secretaries of State Contact Information,* page 27-15.

The following issues should be addressed in an agreement to form a business entity. This list is not all-inclusive.

The Business Entity	
• Name/address of business • Names/addresses of shareholders • Description of business purposes – Products, services, market	• Number and duties of employees • Special allocations for partnerships • Contributions to capital – Loans and repayment guarantees
The Business Owners	
Responsibilities of owners • Administrative duties. • Services to be performed. • Hours dedicated to the business. • Time off. • Length of commitment. **Compensation of owners** • Wages/guaranteed/other payments. • Contributions to retirement funds. **Payment of expenses not covered by business operations** • Stop-loss agreements, percentage contributions in case of shortfall. • Expenses to be paid personally by owners. • Provisions for additional capital contributions. **Decisions and disagreements** • Situations that will require a vote. • Majority or unanimous vote requirements. • Arbitration agreement.	**Divisions of responsibility** • Authority to hire, fire, and train employees. • Authority to make loans, purchase inventory and supplies, enter into contracts, and incur business debts. **Draws** • Scheduled draws. • Limits and restrictions on draws. **Rights of owner withdrawal or transfer of interest** • Ability to withdraw. • Requirements for sale of interest. • Rights of first refusal. • Ability to sell to outside party. • Advance notice of retirement. • Methods of evaluating owner share. **Death of an owner** • Buy/sell agreements, succession plan. • Rights and authority of relatives. • Location of each owner's will. • Right to divide interest of owner.
Books and Records	
Responsibility • Bookkeeping, accounting, and tax compliance. • Legal compliance.	**Recordkeeping** • Fiscal or calendar year. • Accounting method, tax elections. • Location of books and records.
Amendment Provisions	
Circumstances, authority, procedures • Vote required for amendment.	**Situations when amendment is:** • Mandatory • Optional

Corporate Transparency Act (CTA)

The CTA requires a reporting company to disclose ownership information about beneficial owners to the Financial Crimes Enforcement Network (FinCEN). Criminal and civil penalties may apply for failure to comply with CTA requirements.

Reporting company. A reporting company is a corporation, limited liability company (LLC), or other entity formed through registration with a secretary of state or similar agency.

Beneficial owner. A beneficial owner is defined as any individual who exercises substantial control, or who directly or indirectly controls, or owns at least 25% of, a reporting company. The CTA requires disclosure of a beneficial owner's name, date of birth, current address, and a unique identifying number, such as a passport or driver's license number, including an image of the new document.

Reporting timeline. FinCEN issued a final rule implementing the CTA reporting provisions on September 29, 2022. The effective date for the rule is January 1, 2024.

- Reporting companies created or registered before January 1, 2024, will have one year to file their initial reports, while reporting companies created or registered after January 1, 2024, will have 30 days after receiving notice of their creation or registration to file initial reports.
- Reporting companies have 30 days to report changes to the information in their previously filed reports and must correct inaccurate information in previously filed reports within 30 days of when the reporting company becomes aware or has reason to know of the inaccuracy in the earlier reports.

Reporting exceptions. A reporting company is exempt from CTA requirements if all of the following conditions are met.

- Employs more than 20 full-time employees,
- Had revenue of more than $5 million, as reported on a prior-year federal income tax return, and
- Has a physical presence in the United States.

Other entities exempt from reporting include charitable organizations and publicly-traded companies.

Business Plans

Cross References

- IRS Pub. 583, *Starting a Business and Keeping Records*
- Small Business Administration, www.sba.gov

Related Topics

- Employer Identification Number (EIN), page 5-1
- Start-Up/Organizational Costs, page 8-21
- Payroll and Labor Laws, Tab 23

Starting a Business

Starting a business requires the development of plans and agreements. For business tools designed to assist with creation of the business, see *Starting a Business Checklist,* page 27-1, and *Business Agreements,* previous column.

The Purpose of a Business Plan

A business plan is a written document created to detail all aspects of a business on a comprehensive level. Many banks and investors require a written business plan before lending to, or investing in, a business.

Preparation of a Business Plan

A business plan should be targeted to the stakeholders with an interest in the business. If financing is needed, then the content of the business plan should be addressed to investors, bankers, and loan advisors. If outside financing is not needed, then the business plan is useful to communicate the mission, target markets, customers, and operational plans to management and employees.

Updates. Depending on the size of the business and financing needs, the initial business plan may be limited in scope and details. However, the business plan should be modified, expanded and updated at regular intervals. As the business grows, so should the business plan.

Mentors. Mentors are available to help with the preparation and updating of business plans. Consider the use of a SCORE advisor or other mentor to help with starting the business and preparing and/or updating the business plan.

Organization of the Business Plan

The organization of and recommendations for a typical business plan are outlined on page 27-6. A targeted business plan will select content appropriate for the intended audience.

Table of Contents

Executive Summary

The executive summary is an overview of the entire plan. It should be written when all other sections of a business plan are complete. The summary should be less than one page in length and allow a user to gain a basic understanding of the business.

Company Description

Mission. The mission statement should be brief, describing why a business exists and its fundamental purpose.

Vision. The vision statement defines the intended future state of an organization. It sets a high, long-term goal which is used to guide decisions of management and ownership.

Description. The description section defines goals and objectives, business philosophy, target market, industry, and the legal entity.

Products and Services

Provide a detailed description of the products and services the business will offer. Include pricing, unique features, and the required level of quality. Create an appendix for any photos, technical specifications, drawings, or brochures.

Marketing Analysis

Market research blends consumer behavior and economic trends to confirm and improve the business idea. Answer the following questions:

- **Demand.** Is there a desire for the product or service?
- **Market size.** How many people would be interested in the offering?
- **Economic indicators.** What is the income range and employment rate?
- **Location.** Where do customers live and where can the business reach?
- **Market saturation.** How many similar options are already available to consumers?
- **Pricing.** What do potential customers pay for these alternatives?

Market research methods include doing direct research via surveys, questionnaires, focus groups, and in-depth interviews.

Competitive analysis. Analyzing the potential competition can help a business establish a price for its product(s) and/or service(s). A competitive analysis should identify competition by product line or service and market segment. Assess the following characteristics:

- Market share.
- Strengths and weaknesses.
- The window of opportunity to enter the market.
- The importance of the target market to the competitors.
- Any barriers that may hinder market entry.
- Indirect or secondary competitors who may impact success.

Operational Plan

The operational plan details the day-to-day operations of a business. Sections include the following items (if applicable).

Operational Plan Sections

Production	• Production techniques and costs. • Quality control processes. • Customer service processes.	• Inventory control methods. • Product development methods.

continued in next column

Operational Plan Sections continued

Location	• Size and type of space, zoning, and utility requirements. • Required access for customers, clients, suppliers, and shipping. • Estimated costs per month based on research. • Business hours.
Legal Environment	• Required licenses, bonds, and permits. • Health, workplace, or environmental regulations. • Safety regulations, such as OSHA. • Industry or profession specific regulations. • Insurance coverage. • Trademarks, patents, and copyrights.
Personnel	• Number, type, availability, and sourcing of required employees. • Quality of existing staff, if any. • Pay structures, job descriptions, and divisions of labor. • Training and development methods.
Inventory	• Types of inventory to be held. • Planned inventory investment amount. • Seasonal buildups of inventory, if required. • Lead time for ordering.
Security	• Physical security. • Information security, including cybersecurity.
Suppliers	• Key suppliers, including name and address, types and amounts of inventory provided, credit and delivery policies, and history, if any.
Credit Policies	• Determine if credit will be offered to customers and clients. • Establish payment terms and early payment discounts. • Process for determining customer creditworthiness. • Create a plan for resolving slow or non-payment on customer accounts.
Managing Payables	• Create a table listing all vendors and their payment terms. • Establish a priority ranking for each vendor based on level of importance to operations.

Management and Organization

Key employees. Key employees refer to a person or persons who provide unique managerial, technical, marketing, or financial skills. Include in the list the key employees' talent, experience, and distinctive competencies brought to the business. Incorporate job descriptions of key employees, as well as resumes of the owners and key employees if using a business plan to seek financing.

Management continuation plan. In a management continuation plan, cross-training members of a management team is the most effective way to plan for sudden personnel unavailability or departure. The plan should specify the exact procedures for transferring duties when required, including arrangements with vendors, banks, employees, and owners.

If only one person is capable of running daily operations, provisions should be made for locating, training, and paying a manager from outside the organization, or for the wind down of operations.

Organizational chart. If a business has three or more employees, it is best to create an organizational chart outlining which employees report to which managers and the duties of all employees.

Buy-sell agreements. Buy-sell agreements are usually part of a succession plan put in place to protect the financial interests of the owners of closely held companies and their heirs and to protect the company's stability in case of a major event. Funding buy-sell agreements is frequently accomplished using insurance policies under either a cross purchase agreement, or a stock redemption agreement.

Cross purchase agreement. Each owner of the company takes out, and is beneficiary of, an insurance policy on each of the other owners. In the event of an owner's death, the other owners use the insurance proceeds to buy out the decedent's ownership share in the company from the decedent's beneficiaries.

Cross Purchase Agreement	
Advantages	*Disadvantages*
Simple to set up.	The number of polices needed can be cumbersome with multiple owners.
Life insurance proceeds are not taxable to the beneficiary, and the decedent's estate gets stepped-up basis in the ownership interest. The transaction does not result in tax liability for either party.	Because older owners' life insurance premiums will be higher, a disparity in cost is created between older and younger owners.
The transactions occur outside the company. The life insurance proceeds are not subject to claims of the company's creditors.	The agreements must bind the beneficiaries to the agreed-upon transactions, such as selling the deceased owner's interest.
The basis of the remaining owners is increased by the FMV of the interest acquired.	Control can shift when ownership transfers occur under a cross purchase agreement.

Note: See *Employer-owned life insurance contracts,* page 27-10.

Stock redemption agreement. The company takes out life insurance policies on each of the owners. When an owner dies, the company buys out the deceased owner's interest.

Stock Redemption Agreement	
Advantages	*Disadvantages*
Simple to administer with fewer policies required than with a cross purchase agreement.	For a C corporation, insurance proceeds increase E&P, resulting in taxation upon distribution to shareholders.
Cost of policies is split evenly among owners.	Rules about stock redemptions can be complex. Related-party rules can cause unintended consequences.
For a C corporation, the proceeds are not taxable income.	Remaining owners do not benefit from a step-up of basis.
Policies are not subject to the claims of owner's creditors.	Those with the highest shares of ownership pay the most for premiums.

Note: See *Employer-owned life insurance contracts,* page 27-10.

Valuation. Valuation of a company can change significantly in a relatively short time. The buy-sell agreement should be flexible in its ability to accurately reflect changes in value.

In a cross purchase agreement, the company has no interest in the decedent's life insurance proceeds, whereas in a stock redemption, the interest is included with the value of the business. Typically, the redemption price of a stock redemption includes a portion of the life insurance proceeds.

Example #1: Abe and George each own 50% of Cherry Tree Inc., a C corporation. The company is currently valued at $250,000. Under a cross purchase agreement, Abe takes out, and is beneficiary of, a $125,000 life insurance policy on George. George takes out a similar policy on Abe.

The cross purchase agreement is structured so that additional policies can be taken out over time as the value of the company increases.

George dies and Abe collects $125,000 in tax-free proceeds from the life insurance policy. Under the terms of the cross purchase agreement, George's beneficiaries are required to sell his interest in the company to Abe for $125,000. Since the basis of George's interest is stepped up to FMV on the date of death, George's beneficiaries do not recognize taxable income.

After the transaction, Abe owns 100% of the company. George's beneficiaries receive $125,000 cash, which is not taxable to them.

Example #2: Assume the same facts as Example #1, except the buy-sell agreement is funded by a stock redemption agreement. Cherry Tree Inc. takes out, and is beneficiary of, a life insurance policy on Abe in the amount of $125,000, and a similar policy on George.

When George dies, Cherry Tree Inc. receives $125,000 in life insurance proceeds. The proceeds are not taxable to Cherry Tree Inc., but the $125,000 in life insurance proceeds do increase the corporation's earnings and profits (E&P) so the amounts will be taxable if distributed to shareholders as dividends. Cherry Tree Inc. uses the proceeds to purchase George's ownership interest from his beneficiaries. George's ownership interest was stepped up at his date of death so his beneficiaries do not recognize taxable income on the transaction. Abe now owns 100% of the outstanding stock of the corporation.

Funding

Determine sources of funding for the business. Funding can include:

- Self-funding.
- Loans, including SBA-guaranteed loans.
- SBA investment programs, including Small Business Investment Company (SBIC), Small Business Innovation Research (SBIR), or Small Business Technology Transfer (STTR).
- Venture capital from investors.
- Crowdfunding.

Personal financial statement. A personal financial statement (PFS) is a balance sheet for each owner on an individual basis. It includes values and detail of all assets owned, as well as amounts and terms for all debt obligations. When applying for financing, most banks will require a personal guarantee, assuring if the business is unable to pay back the debt, the individual owners will do so. Having a PFS from all owners establishes that sufficient net assets exist to repay the loan. If the owner has not created a PFS in the past, significant documentation, as well as estimates, will be required. The *Personal Financial Statement Summary,* below, can be used to assemble a basic PFS.

Personal Financial Statement Summary			
Assets	*Amount*	*Liabilities*	*Amount*
Cash accounts	$	Credit cards, lines of credit	$
Securities—stocks/ bonds/mutual funds	$	Loans	$
Life insurance—cash value	$	Loan on life insurance	$
Personal assets (autos, jewelry, etc.)	$	Taxes payable	$
Retirement funds	$	Mortgages	$
Real estate	$	Other debts	$
Other assets	$	Other liabilities (specify)	$
Total Assets	$	*Total Liabilities*	$
Net Worth	$		

Net worth. Net worth is the value of all assets, less all liabilities. It is the most useful measure of financial resources.

Personal assets. Personal assets are all physical assets owned by an individual which are not real estate or business-use property. They include, but are not limited to, cars, trucks, boats, furniture, jewelry, art, clothing, and electronics. Most of the time the value of personal assets is an estimate as many individuals do not have a cumulative total and full appraisals are prohibitively expensive.

Start-up costs. Start-up costs are incurred before the start of operations. Typical expenses include the costs of organization, professional consulting, capital equipment acquisition, and leasing a space. Researching these costs to develop realistic estimates, in addition to the information in the financial plan, will allow a business to seek the proper amount of capital. See *Start-Up Costs,* page 8-21.

Capital. Cash from the owners or investors is the most common source of capital when beginning a new entity. Business loans are also common and can be secured through private banks or the Small Business Administration (SBA) loan guarantee program. Compare differences among entities for capital contributions and loans in *C Corporations,* Tab 18, *S Corporations,* Tab 19, and *Partnerships and LLCs,* Tab 20.

SBA loans. The SBA is a federal agency which guarantees certain loans and lines of credit made by banks to small businesses. Loans and lines are available for working capital, asset purchase, and debt refinancing needs. See *Financing—Small Business Administration,* page 27-14.

Debt covenants. Debt covenants are requirements placed on businesses borrowing money and those guaranteeing a debt. In most cases, violating debt covenants will place a debt into technical default, even if required payments are being made on time. Technical default may trigger accelerated payments, increased interest rates, or immediate repayment of an entire debt. Assets used to secure a debt which falls into technical default may be repossessed to satisfy the debt obligation.

Example: Dina starts a business making and selling purses. She takes out a loan for production costs, using the value of her stock portfolio to guarantee repayment. As a debt covenant, the bank requires the portfolio to maintain a minimum value. Subsequently, the value of her portfolio decreases substantially below the minimum value, and the bank demands immediate repayment of the loan.

Crowdfunding. Crowdfunding raises funds for a business from a large number of people. Individuals who contribute to crowdfunding campaigns are not technically investors because they do not receive a share of ownership in the business and do not expect a financial return on their money. Individuals generally receive gifts as thanks for their contribution. Crowdfunding is low risk for business owners.

Financial Projection

Forecasting cash flow. Cash flow is made up of the streams of cash into and out of a business. For new businesses, cash flow, more than profit, is the best indicator of whether a business will survive. It determines whether a business will be able to pay its expenses and debts as they come due.

Projecting cash flow for the first 12 months of a new business will help the owners to determine:

- The amount of cash a business will collect from sales,
- The amounts of cash a business will pay out for expenses and capital equipment, and
- The need for additional cash to pay operating expenses.

When completing a cash flow forecast, it is best to use pragmatic estimates of cash to be received from sales. A "Contingencies" item is used to allow for unforeseen expenses, or for expenses which are higher than expected.

Using a separate contingency item, rather than simply adding a percentage to all anticipated expenses, will allow a business to better measure the actual performance against expectations. A suggested contingency allowance is 20% of all other anticipated expenses. See the *Projected Cash Flow (12 Months) Worksheet,* page 27-9.

Author's Comment: Cash flow is the most important financial element to manage in a small business. Slow collections from clients, unmanageable overhead and debt loads, as well as lack of ability to borrow, have led to the failure of many small businesses. Managing cash is a daily process in large companies, and small business would be wise to follow suit.

Forecasting Profit and Loss

12-month forecasted profit and loss statement. A 12-month forecasted profit and loss statement details the level of profitability and items which contribute to it. This statement will differ from the forecasted cash flow statement, depending on the accounting method of a business.

For cash-basis businesses, the primary difference between the forecasted profit and loss statement and the forecasted cash flow statement is payments which are not currently deductible expenses, such as capital asset purchases and the principal portion of loan payments. In addition, capital contributions or distributions by owners will not be included. All other expenses, as well as income, are included in the period they are paid or received.

The difference for accrual basis businesses, in addition to those for cash basis businesses, is the use of accounts receivable, accounts payable, and prepaid expenses.

Monthly Sales Forecast

Company Name:

Fiscal Year Begins:

Month:

Product or service units sold		Product or service units sold	
Sale price per unit		Sale price per unit	
Item 1 Total:		**Item 2 Total:**	
		Monthly Totals— All Categories:	

Instructions: Fill in numbers for each product or service to be sold. Multiply the units sold by the sale price per unit to get total sales per item per month. Expand the number of items as needed.

Accounts receivable and payable. Accounts receivable is used to record invoices not yet paid by clients but recorded as income when earned. Similarly, accounts payable is used to record amounts not yet paid to vendors that have been included in expenses when incurred. These rules cause some income and expenses to be recognized without the associated cash flows.

Prepaid expenses. Prepaid expenses are amounts paid in advance of the due date, or paid in one lump sum. When paid, the expenses are recorded as an asset on the balance sheet and expensed each period as the benefit is received.

Example: Tantini, Inc. pays its yearly insurance premium of $1,200 in one payment on January 1. The $1,200 is recorded as a prepaid expense and $100 is expensed each month as insurance expense.

Using the forecasted profit and loss. The forecasted profit and loss is used to determine sales or client requirements to aid in the building of a business and enable a business to measure success in these areas against specific goals. When used in conjunction with the marketing plan and product or service pricing, the forecasted profit and loss assists in determining how much of each product or service must be sold during a given month to achieve profitability. The statement is often requested when applying for new financing or renewing existing debt obligations.

Fixed and variable costs. All costs in a business fit into one of these two classifications, but never both. Fixed costs are costs a business will incur regardless of the level of sales or service. Variable costs are costs which change as the volume of sales changes and are usually expressed as a percentage of sales.

Examples of Fixed vs. Variable Costs

Fixed Costs		*Variable Costs*	
• Salaries	• Rent	• Raw Materials	• Finished Goods
• Insurance	• Interest	• Inventory	• Direct (Production) Labor

Example: CAS, Inc. manufactures sunglasses. For each pair it sells, the frame costs $2.50, the lenses cost $1.25, and the labor to produce the pair is $3. Each pair sells for $20. CAS' variable cost percentage is as follows:

Total cost per pair	$ 6.75
Sale price per pair	$20.00
Variable cost percentage	$6.75 ÷ $20.00 = 33.75%

Breakeven analysis. A breakeven analysis will determine the level of sales at which a company will cover all its fixed and variable costs. This level is referred to as the breakeven point and can be expressed in either sales revenue or units of sale, and for service-based businesses, in hours billed.

Example: Tantini, Inc. produces children's plastic cups. The company's fixed costs are $3,000 per month, and the cost to produce each cup is $4. The cups are sold for $10 each. Tantini's breakeven point is as follows:

Sale price per cup	$ 10
Less: production costs per cup	$ (4)
Gross profit per cup	$ 6
Fixed costs per month	$3,000
Unit breakeven point	$3,000 ÷ $6 = 500 cups
Revenue breakeven point	($3,000 ÷ $6) × $10 = $5,000

Projected balance sheet. A projected balance sheet uses forecasted financial statements to project what a company will own and what it will owe at the end of the projection period.

Projected Cash Flow (12 Months) Worksheet

Cash In		Pre Start-Up Estimate	Month
1) **Initial cash position**	1)		
2) Cash sales	2)		
3) Collections from sales made on credit	3)		
4) Loan or line of credit proceeds	4)		
5) **Total cash receipts** (add lines 2–4)	5)		
6) **Total cash available** (add lines 1 and 5)	6)		

Cash Paid Out		Pre Start-Up Estimate	Month
7) Accounting and legal	7)		
8) Advertising	8)		
9) Auto expenses	9)		
10) Contractors and consultants	10)		
11) Deposits and retainers	11)		
12) Gross payroll	12)		
13) Insurance	13)		
14) Interest	14)		
15) Inventory purchases	15)		
16) Miscellaneous	16)		
17) Office supplies	17)		
18) Payroll taxes and fees	18)		
19) Postage and delivery	19)		
20) Raw material purchases	20)		
21) Real estate taxes	21)		
22) Rent	22)		
23) Repairs and maintenance	23)		
24) Sales taxes	24)		
25) Telephone	25)		
26) Utilities	26)		
27) **Total expenses** (add lines 7–26)	27)		
28) Loan principal payment	28)		
29) Capital asset purchases	29)		
30) Other start-up costs	30)		
31) Contingencies	31)		
32) Owners' withdrawals	32)		
33) **Total cash paid out** (add lines 27–32)	33)		
34) **Ending cash position** (line 6 minus line 33)	34)		

Use of Budgets in Ongoing Operations

Annual budget. Development of an annual budget generally takes place late in the year prior to the year of the budget and is broken down by month. Financial statements from recently completed periods are used to develop estimates for the budget. Using the budget, costs can be reduced, resources properly allocated, and new goals for the year can be set.

Budget variance. Budget variance is the difference between budget expectations and actual results. Actual results should be compared to the budget at the end of each month or quarter to adjust sales and spending to accomplish the budget objectives.

Internal Control, Accounting Procedures, and Insurance

Cross References

- Small Business Administration, www.sba.gov

Related Topics

- Insurance, page 8-6
- IRS Audits, page 15-7
- Minimum Income Probes, Tab 33

Internal Control

Control procedures. Internal control procedures are designed to safeguard the assets of a business. Without them, dishonest employees or owners can misappropriate assets in the form of cash, property, or supplies with little effort.

Separation of duties. Duties which, if conducted by the same individual, would allow for simple concealment of theft should be kept separate. The following duties should be performed by different people.

- Receiving, recording, and depositing customer payments.
- Sourcing, approving, ordering, and receiving supplies or merchandise.
- Inputting, approving for payment, and paying vendor bills and payroll.
- Balancing and inputting transactions into bank accounts.
- Counting cash and merchandise on hand at the beginning and end of the day.

Small businesses generally lack sufficient staff to properly separate all duties which should be separated. In this case, increased involvement of owners and management in daily operations of a business can assist in detecting misappropriation of assets by an employee, manager, or owner.

Mandatory vacations. Many schemes to steal from a business require constant, manual intervention by the person perpetrating the scheme. By having and enforcing a mandatory vacation policy, the time a perpetrator spends away from work may allow a scheme to be uncovered in the course of daily operations.

Environment of detection. If an employee or owner believes embezzlement will be discovered in the normal course of business, it is much less likely one would choose to embezzle. Creating an environment of detection is the process of alerting all employees and owners that systems are in place to detect embezzlement and theft, and that such acts will be prosecuted if perpetrated. This can be accomplished through training, one-on-one conversations, and the establishment of a hotline employees and owners can use to report suspected theft.

Awareness of others. If a manager notices an employee has recently purchased an expensive new car, has begun taking exotic vacations, or wearing designer clothing, and knows the employee's income cannot support the new lifestyle, additional scrutiny may be warranted.

Background checks. Background checks during the hiring process allow a business to determine whether a prospective employee has any criminal history. Many background checks also include credit histories to uncover any financial conditions which may make an employee more likely to steal from a business.

Cybersecurity. Small businesses are becoming more common targets for attacks on their information and systems. Information that needs to be secure includes:
• Employee personal information,
• Owner, partner, and shareholder information,
• Customer, client, and supplier information,
• Financial and sensitive business information, and
• Tax returns.

Threats. Threats include website tampering, theft of data, denial of service attacks, malicious code, and viruses.

Vulnerabilities. Vulnerabilities can be caused by outdated or insecure computer systems, poor or missing security policies, missing procedures, and loose enforcement of existing policies.

Security steps. Steps to improve security include:
• Training and education,
• Best internet, email, and desktop practices,
• Protection of computers and systems, and
• Backup procedures.

Tax returns. See *Tax-Related Identity Theft,* page 14-13.

For strengthening cybersecurity, go to www.sba.gov/business-guide/manage-your-business/strengthen-your-cybersecurity.

Accounting Procedures

Schedule of procedures. Whether a business does bookkeeping and accounting internally, or has it completed by a professional, the following schedule provides a guideline of recommended timing.

Accounting Procedure Schedule

Daily	*Monthly*	*Quarterly*	*Annually*
Count and record cash on hand.	Reconcile business deposit and credit accounts.	Compile a quarterly and year-to-date profit and loss.	Compile an annual profit and loss and balance sheet.
Record sales and returns in accounting system.	Reconcile long term liabilities, record depreciation. Compile profit and loss and balance sheet.	Compare completed financial statements to budget.	Renew loans and lines of credit as required.
Deposit payments received.	Deposit employment taxes.	Calculate and pay any required estimated tax payments.	Complete required tax returns.
Back up accounting data.	Review financial statements with ownership and senior management.	Review debt covenants to compliance.	Create the budget for the next business year.

Insurance

Types of insurance. The following types of insurance should be considered by every business.
• Key person life insurance,
• Disability insurance,
• Employer-owned life insurance contracts, and
• Liability insurance.

Insurance is particularly important in sole proprietorships and general partnerships, as these entity types offer no liability protection on their own.

Key person life insurance. Many business owners are required to sign personal guarantees to secure business debt. In the event of an owner's death, these debts will remain and, if unpaid by the business, will become the responsibility of the owner's heirs. By taking out life insurance on the owner, proceeds can be used to retire the debt. The proceeds can also be used to fund the search for a replacement to the deceased business owner or to fund obligations to the owner's spouse, such as continuing medical insurance coverage or salary payments. The premium payments by the business are not deductible, and the proceeds from the policy are not taxed as income.

Disability insurance. Disability insurance protects the earnings of employees and business owners by providing a stream of payments when a disability resulting in the loss of ability to work occurs.

Typical Disability Insurance Features

	Short-Term Disability	*Long-Term Disability*
Delay from date of disability to benefits	0 to 14 days	3 weeks to 3 months
Coverage term	Up to 2 years	Generally to age 65
Benefit amount	50 – 70% of salary	50 – 70% of salary

Employer-owned life insurance contracts. For certain employer-owned life insurance contracts issued after August 17, 2006, the amount of death benefits excluded from income shall not exceed an amount equal to the sum of the premiums and other amounts paid by the policyholder for the contract. [IRC §101(j)(1)]

Form 8925, *Report of Employer-Owned Life Insurance Contracts.* Form 8925 is used to report the number of employees covered by employer-owned life insurance contracts (issued after August 17, 2006) and the total amount of life insurance in force on those employees at the end of the tax year.

Liability insurance. Liability insurance generally covers damages to compensate the injured party, known as compensatory damages. Policies also may cover general damages which have not been otherwise classified, as well as the costs of defense in a liability lawsuit. Punitive damages awarded to punish an intentional act by a business are generally not covered by any policy.

Insurance Policy Types

Type of Policy	*Coverage*
Product Liability	Protects against claims made by customers injured by the products of a business.
Professional Liability	Covers damages arising from errors and omissions arising from the performance of services by a business.
Employee Dishonesty	Covers financial losses due to employee(s) theft of money, property or securities of the employer.
General Liability	Covers general liabilities arising in the normal course of business.
Liability Umbrella	Covers the portion of damages awarded which are beyond the coverage limits of other liability policies.

continued on next page

Insurance Policy Types continued	
Type of Policy	*Coverage*
Property and Casualty (P&C)	P&C insurance covers the property of a business against theft or destruction, including that which is caused by sudden, unexpected events. Some level of liability protection for the property covered is also generally included.

SWOT Analysis

SWOT stands for "Strengths, Weaknesses, Opportunities and Threats." It is a strategic analysis tool which is used to adjust operations in light of changing business conditions, both inside and outside an organization. A SWOT analysis ascertains the ability of a business to achieve a certain objective by quickly identifying all factors affecting success.

Strengths. Strengths are areas within a business which give it an advantage in meeting the objective. Processes, people, structure, and reputation are all examples of strengths. Once strengths are identified, the next step is to determine how to best capitalize upon them to move toward meeting the objective.

Weaknesses. Weaknesses are areas existing inside an organization that need improvement for the objective to be met. Shortage of staff, lack of facilities, and lack of sufficient capital are examples of a weakness. Once identified, a plan should be implemented to improve each weakness.

Opportunities. Opportunities exist outside an organization and are out of its control. Advances in technology, changes in government regulation, and condition of the economy are examples of opportunities. Once identified, opportunities should be leveraged to a business' advantage.

Threats. Threats are factors existing outside a business and beyond its control, which could impede the progress of a business toward the objective. Political changes, increased competition, and decreased demand are examples of threats. Once threats are identified, steps should be taken to mitigate their effects.

Reasons Businesses Fail

Failure rates. The failure rate for business start-ups is high. Estimates range from 60% to 90% within the first few years of operation. Rates vary according to the type of business among other factors.

10 reasons for failure. 10 common reasons for failure include:

1) ***Lack of experience.*** This can apply to either a business owner's lack of experience in what a business does or in running a business in general.
2) ***Insufficient capital.*** Many businesses take a year or more to begin funding daily operations through cash flow generated by sales or services provided. Sufficient capital must be in place to support a business through this period.
3) ***Poor location.*** Location can be one of the most important factors for business success or failure.
4) ***Poor inventory management.*** Keeping too much inventory uses too much capital unnecessarily, while having too little inventory can lead to shortages and customer dissatisfaction.
5) ***Over-investment in fixed assets.*** Investing too much too quickly in long-lived assets also uses much needed capital in an unnecessary way.
6) ***Poor credit arrangements.*** Lacking access to sufficient, reasonably priced credit can create cash flow problems if sales decline or customers do not pay a business in a timely manner.
7) ***Personal use of business funds.*** Business funds should not be used for personal purposes. Such use can leave a business without sufficient cash or available credit to fund operations.
8) ***Low sales.*** Poor knowledge of the market can result in lower than expected sales.
9) ***Competition.*** Not properly assessing competition can potentially leave a business in a position of needing to compete in a market where it cannot do so and survive.
10) ***Unexpected growth.*** Growth without sufficient planning for the consequences can lead a thriving business to failure.

Remitting taxes collected. Businesses required to collect sales tax must remit the amounts collected to the appropriate state and local agencies as required by law. Failure to do so can cause loss of a sales tax license, barring a business from selling its products. Collecting and not remitting tax can be prosecuted as a criminal offense under certain circumstances.

Going Out of Business Tax Checklist

In the event a business goes out of business, a tax return must be filed for the final year of operation. See the following chart for a list of final forms and schedules to be filed.

Going Out of Business Tax Checklist	
Tax Liability	*Form or Schedule (If Applicable)*
Income tax	• Schedule C (Form 1040), *Profit or Loss From Business.* • Schedule F (Form 1040), *Profit or Loss From Farming.* • Form 1065, *U.S. Return of Partnership Income.* • Form 1120, *U.S. Corporation Income Tax Return.* • Form 1120-S, *U.S. Income Tax Return for an S Corporation.* • Form 4797, *Sales of Business Property,* with the tax return. • Form 8594, *Asset Acquisition Statement,* with the tax return. • Schedule D (Forms 1040, 1065, 1120, 1120-S), *Capital Gains and Losses.* • Schedule K-1 (Forms 1065, 1120-S), *Partner's/Shareholder's Share of Income, Deductions, Credits, etc.*
Self-employment tax	Schedule SE (Form 1040), *Self-Employment Tax,* with the taxpayer's Form 1040.
Employment taxes	• Form 941, *Employer's Quarterly Federal Tax Return.* • Form 940, *Employer's Annual Federal Unemployment (FUTA), Tax Return.* • Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees.*
Information Returns	• Form W-2, *Wage and Tax Statement.* • Form W-3, *Transmittal of Wage and Tax Statements.* • Form 966, *Corporate Dissolution or Liquidation.* • Form 1099-DIV, *Dividends and Distributions.* • Form 1099-MISC, *Miscellaneous Information.* • Form 1099-NEC, *Nonemployee Compensation.* • Form 1096, *Annual Summary and Transmittal of U.S. Information Returns.* • Form 5500, *Annual Return/Report of Employee Benefit Plan.* • Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips.*

A taxpayer should consider dissolving an S corporation, partnership, or LLC and check appropriate boxes to indicate final tax returns.

Note: The above list pertains to tax returns only. When a business is closed, the owner should consult with professional advisors concerning the business and legal steps to close out the business. Also see *Corporate Liquidations,* page 18-22, *S Corporation Liquidation,* page 19-13, and *Terminating a Partnership,* page 20-19.

Succession Planning

Succession planning is the process of researching, defining and implementing a plan for the eventual departure of business leaders and owners. The length of time and complexity of the plan are directly related to the size and complexity of the business creating the plan.

Since the changes in culture and operations associated with a change in leadership or ownership occur gradually, having a succession plan in place makes a change a smooth process. The business is allowed to continue to operate without the distractions of managing the effects of a sudden departure.

Management succession planning. Management succession planning develops a pool of succession candidates who could take over the responsibilities of a current leader upon their expected departure.

1) ***Analysis.*** Analysis involves researching the expected challenges facing a business and the industry and market in which it operates over the expected length of the succession plan. Through this research, a clear understanding can be developed of the skills and characteristics required of the succession candidates.
2) ***Development.*** Development of the succession candidates differs based on whether they exist inside or outside the business. For internal candidates, rotations through different roles the candidate will eventually manage are common and effective, as are increased levels of responsibility and higher levels of training. External candidates can be more difficult to develop for succession and generally must be brought into the business before development can begin.
3) ***Selection.*** The selection of a single succession candidate is done after the development step is completed, usually just before the current leader is due to leave the business. The selection process consists of reviewing each of the succession candidates and selecting the one with the highest probability of success based on the review.
4) ***Transition.*** The transition process begins when the current leader departs and can continue for up to a year, depending on the size and complexity of the business and the responsibilities being transitioned. In cases where the former leader left on good terms, they may be kept on in a consulting role to assist the new leader in taking over their former role.

Ownership succession planning. Ownership succession planning involves planning for the eventual departure of an owner from a business through retirement, death, or in some cases, removal by other owners. In cases involving some small businesses, ownership and management succession planning are closely linked. Generally, ownership succession is achieved through one of four methods.

1) ***Sale of business to an outside party.*** In this case, a business is sold as a whole to someone outside the business. The sale of the business may be of the underlying assets or of the C or S corporate stock or partner or member interests. In the case of sole proprietorships, the sale is limited to the sale of business assets. A thorough business valuation should be conducted. See *Methods,* next column.
2) ***Sale of business to other owners.*** The sale of a business ownership interest to other current owners should be planned and executed through buy-sell or cross-purchase agreements. See *Buy-sell agreements,* page 27-6.
3) ***Transition at death.*** Some business owners choose to pass ownership in a business to their heirs at death. This type of ownership succession involves planning for potential tax and estate consequences.
4) ***Employee stock ownership plan (ESOP).*** Businesses with employees can choose to establish an ESOP, which is a type of retirement plan. The business owner can then sell their ownership shares to a trust which holds the shares on behalf of the ESOP.

   This process allows owners to convert the equity owned in the business into cash and provides an additional retirement benefit for the employees. Special rules exist regarding the taxation of the sale of stock to the trust of the ESOP.

Business Valuation

A business valuation is the process of determining what a business is worth for a number of different purposes. Business valuations not only help set a reasonable sale price for the business, but also assist in determining how much money the business can borrow, as well as the level of complexity required in completing estate planning for the owners.

Business valuations are generally completed by a business broker, certified valuation analyst, or mergers and acquisitions specialists.

Methods. There are a number of methods for completing a business valuation. The best method to use will be based on the type and complexity of the business undergoing valuation, as well as the purpose of the valuation. The following are a few common methods.

Adjusted book value. Based on information on the balance sheet, the calculation involves determining the fair market value of the assets and subtracting the liabilities of the business.

Capitalized adjusted earnings. This method involves determining the discretionary cash flow of the business over several prior periods of time and using factors surrounding risk and interest rates to determine the value of the business.

Discounted future earnings. This is an expanded version of the capitalized adjusted earnings method which takes into account the expected growth rates of the business over a number of future periods.

Hiring Practices

Cross References

- Equal Pay Act of 1963
- Title VII of the Civil Rights Act of 1964
- Age Discrimination in Employment Act of 1967
- Titles I and V of the Americans with Disabilities Act of 1990
- Civil Rights Act of 1991
- Family and Medical Leave Act of 1993
- Genetic Information Nondiscrimination Act of 2008

Related Topics

- Employee Benefits, Tab 22
- Payroll and Labor Laws, Tab 23

Avoiding Improper Interview Questions

There are a number of federal laws which govern the hiring of employees. Planning should be undertaken to avoid job ads and interview questions which are improper or illegal. A general rule is to only ask questions which directly relate to the interviewee's ability to perform the job and to create job requirements which avoid discrimination. A partial list is provided below.

Examples of Improper and Proper Interview Questions

Improper	*Proper*	*To Avoid Possible*
How old are you?	Are you over age 18?	Age discrimination.
Is that your maiden name?	Have you gone by any other names in the past?	Discrimination based on marital status or sexual orientation.
Are you married?	Marital status is not relevant to employment.	Discrimination based on marital status or sexual orientation.
Are you a U.S. citizen?	Are you legally authorized to work in the U.S.?	Discrimination based on national origin.

continued on next page

Examples of Improper and Proper Interview Questions continued		
Improper	*Proper*	*To Avoid Possible*
Which religious holidays do you observe?	Are you able to work the schedule required for the job?	Discrimination based on religious affiliation.
Do you have or plan to have children?	Are you available to work overtime or travel as needed?	Discrimination based on marital status or sexual orientation.
Do you have any disabilities?	Are you able to perform the specific duties of this position?	Discrimination based on physical or mental disability.

U.S. Equal Employment Opportunity Commission (EEOC). The U.S. EEOC enforces federal employment nondiscrimination laws. See *Equal Employment Opportunity Laws* chart, page 27-1.

Legal Considerations

Cross References

- U.S. Patent Act of 1952
- U.S. Copyright Act of 1976

Related Topics

- Legal Aspects of Corporations, page 18-2

Truth in Advertising

The Federal Trade Commission (FTC) is the federal agency charged with regulating print and broadcast advertising nationwide. All states also have laws regulating advertising on a local level. All advertising must comply with the following rules.

Truthful and nondeceptive. For an ad to be truthful and nondeceptive, the ad must not contain any information which would be likely to mislead a consumer and which is important to a consumer's decision to buy or use the product or service. The ad cannot omit any information which would mislead or impact a consumer's decision to buy or use the product or service based on the omission.

Reasonable basis for claims made. Any advertiser must have objective evidence to support claims made within an ad. Ads which contain health or safety claims must generally be supported by competent and reliable scientific evidence. Customer testimonials are not considered objective evidence.

Not unfair. An ad is considered unfair if it causes, or is likely to cause, substantial consumer injury which a consumer could not reasonably avoid, and the risk of consumer injury is not outweighed by the benefit provided.

Special situations. Specific rules are in place regarding advertising for consumer leases, offers of credit, 900 telephone numbers, and products sold through mail-order or telephone sales.

For additional information on truth in advertising, visit the FTCs website at www.ftc.gov.

Patents, Trademarks, and Copyrights

Patents. Patents grant the owner of a patent the right to prevent others from making, using, offering for sale or selling an invention in the U.S., or importing the invention into the U.S. Patents are issued by the U.S. Patent and Trademark office and generally have a life of 20 years from the date of issue.

Once issued, a patent holder must enforce the patent rights with-out assistance from the government. Patents cover the following items.

- Utility patents may be granted to anyone who invents or discovers a new, useful process, machine, article of manufacture, composition of matter, or a new and useful improvement thereon.
- Design patents may be granted to anyone who invents a new, original, and ornamental design for an article of manufacture.
- Plant patents may be granted to anyone who invents or discovers and asexually reproduces any distinct and new variety of plant.

Trademarks. Trademarks are words, names, symbols, or devices used in the trade of goods which indicate the source of the goods and also distinguish them from other goods. Servicemarks are used in a similar way except servicemarks are used for services rather than goods. The terms "trademark" and "mark" are widely used to refer to both trademarks and servicemarks.

The rights granted by trademarks prevent others from using the same or confusingly similar marks, but do not prevent others from producing the same goods or services. Trademarks used in interstate or foreign commerce may be registered with the U.S. Patent and Trademark Office.

Copyrights. A copyright, or copyright protection, is used to protect authors of original works of authorship against unauthorized reproduction of their work. Copyrights need not be registered with the U.S. Copyright Office, though doing so will assist the owner of a copyright in enforcing any violations. Owners of a copyright are given the exclusive right to do and authorize others to do the following.

- Reproduce the work in copies.
- Prepare derivative works based upon the work (such as sequels).
- Distribute copies of the work by public sale, rental, lease, or lending.
- Display or perform the work publicly.
- Digitally transmit audio in the case of sound recordings.

For additional detail on copyrights, go to www.copyright.gov.

Contracts

All contracts must have certain terms and conditions to be valid and legally binding. Violating any of the terms and conditions below can result in a breach of contract, allowing the injured party to sue for damages.

Mutual consent. Mutual consent means both parties have a mutual understanding of what the contract covers.

Example: Howard offers to sell Louise a cow for $1,000, and Louise accepts the offer. If Howard believes he is offering to sell a piece of livestock, and Louise believes she is buying a collectible figurine of a cow, no mutual consent has been reached, and no contract is in place.

Offer and acceptance. An offer to buy or sell must be made and accepted in its original terms to be binding.

Note: A counteroffer is a rejection of the original offer, not acceptance. A seller is not required to accept a counteroffer or to sell a product or service under the conditions and terms of an original offer to sell. The same applies to offers to buy.

Example: Howard offers to sell Louise a cow for $1,000. Louise counteroffers $750 for the cow. Howard rejects the counteroffer, and sells the cow to Morgan. Louise cannot sue to enforce the original offer to sell the cow to her for $1,000 because her counteroffer was rejected.

Mutual consideration. Both parties to a contract must give up and receive something of value.

Example: Morgan buys a cow from Howard for $750. Morgan gives up $750 and receives a cow, and Howard gives up a cow and receives $750.

Performance or delivery. A contract must require the performance of tasks or delivery of value.

Example: The contract between Howard and Morgan for the cow requires Howard to deliver the cow and Morgan to deliver the payment. If Howard delivers the cow, he can sue to force Morgan to deliver the payment and vice versa.

Good faith. Both a buyer and a seller must act in good faith, not entering into a contract with intent to breach.

Example: If Howard enters into a contract to sell Morgan a live cow, with the intent of in fact delivering a collectible figurine, he has not acted in good faith.

No violation of public policy. Contract terms cannot violate public policy, such as federal, state, or local laws. An agreement for something that is illegal is not enforceable as a contract.

Example: If a cow Howard sells to Morgan is in fact stolen, and does not belong to Howard, the agreement violates the law against possessing and selling stolen property and is not enforceable as a contract.

Financing— Small Business Administration

Cross References

- Website: www.sba.gov
- Email: answerdesk@sba.gov
- Phone: 800-U-ASK-SBA (800-827-5722)

Related Topics

- Interest Paid—Itemized Deductions, page 4-9
- Loan guarantees, page 19-11

The Small Business Administration (SBA) administers a variety of loan programs. The SBA sets the guidelines for the loans while commercial lenders, community development organizations, and microlending institutions make the loans to small businesses. The SBA backs those loans with a guaranty that will eliminate some of the risk to the lending partners.

Applications for SBA loans can be made online: go to https://www.sba.gov and follow the Funding Programs, Loans link at the top of the page.

7(a) Loan Program

The 7(a) loan serves as the SBAs primary business loan program to help qualified small businesses obtain financing. Financing under this program can be guaranteed for a variety of general business purposes.

Loan proceeds can be used for most sound business purposes including working capital, machinery and equipment, furniture and fixtures, land and buildings (including purchase, renovation and new construction), leasehold improvements, and debt refinancing (under special conditions). The terms and conditions, like the guaranty percentage and loan amount, may vary by the type of loan.

The 7(a) loan program is geared toward start-up and existing small businesses and is delivered through commercial lending institutions.

Certified Development Company (CDC), 504 Loan Program

The SBA 504 Loan Program provides long-term, fixed-rate financing to small businesses to acquire real estate or machinery or equipment for expansion or modernization. Typically this will include:

- A loan secured from a private-sector lender with a senior lien covering up to 50% of the project cost,
- A loan secured from a CDC (funded by a 100% SBA-guaranteed debenture) with a junior lien covering up to 40% of the total cost, and
- A contribution of at least 10% equity from the borrower.

A CDC loan is geared toward small businesses requiring "brick and mortar" financing and is delivered by certified development companies.

Microloan Program

A microloan program provides short-term loans of up to $50,000 to small businesses and not-for-profit childcare centers for working capital or the purchase of inventory, supplies, furniture, fixtures, machinery and/or equipment. Proceeds cannot be used to pay existing debts or to purchase real estate. The SBA makes or guarantees a loan to an intermediary, who in turn makes the microloan to the applicant. These organizations also provide management and technical assistance. The loans are not guaranteed by the SBA. The microloan program is available in selected locations in most states.

Disaster Loans

The SBA provides low-interest, long-term loans for physical and economic damage caused by a declared disaster. SBA disaster loans can be used to repair or replace items destroyed or damaged in a declared disaster area including real estate, personal property, machinery and equipment, inventory and business assets. Businesses of any size and most private nonprofit organizations may apply for physical disaster loans.

Economic injury disaster loan. Businesses that have suffered substantial economic injury that are located in a declared disaster area may be eligible for an economic injury disaster loan. Businesses that qualify are small businesses, small agricultural cooperatives, and most private nonprofit organizations. Economic damage means the business is unable to meet its obligations and to pay its ordinary and necessary operating expenses. A business may qualify for both an economic injury disaster loan and a physical disaster loan.

Flood assistance. The SBA advises that an individual having flood insurance first contact their insurance company. In the event that individual does not have flood insurance, then contact FEMA because assistance may come in the form of grants which do not have to be paid back. In addition, SBA disaster loans can provide eligible homeowners, renters, nonprofit organizations and businesses with access to funds needed to rebuild particularly when damages are not covered by insurance or other forms of assistance.

Index of disaster areas. A searchable index of areas of the country with disaster declarations is at https://disasterloanassistance.sba.gov/ela/s/search-declarations.

For information on deducting disaster losses, see *Casualty and Theft Losses,* page 4-21.

Book to Tax Adjustments

Cross References

- Schedule M-1, *Reconciliation of Income(Loss) per Books With Income(Loss) Per Return,* Forms 1120, 1120-S, and 1065
- Reg. §1.312-6, *Earnings and profits*

Related Topics

- Accounting Periods and Methods, page 8-22
- Earnings and Profits (E&P), page 18-17
- Schedule L, Balance Sheet per Books, page 18-28

• Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return, page 18-28

Income per Books vs. Taxable Income

Income for bookkeeping purposes is not the same as income for income tax purposes. Books and records for business entities should be set up under a system that records income and expenses as it affects earnings available for distribution to the owners without depleting capital. The tax return, on the other hand, reports income and expenses as it affects earnings that are subject to tax.

Example: Judy and Kathy are each 50% owners in JK, Inc. The corporation owns a mutual fund that earns tax-exempt interest from municipal bonds. The tax-exempt income is not reported as taxable income on the corporation tax return. However, the tax-exempt income does increase the amount of money that is available for distribution to Judy and Kathy without having to deplete contributed capital. Therefore, the municipal bond interest is recorded on the corporation income statement as income, which in turn increases net income per books. The net income per books is thus different than net taxable income on the corporation tax return.

Generally accepted accounting principles (GAAP). GAAP is a system of recording financial data according to accounting principles conforming to statements, opinions and interpretations issued by the American Institute of Certified Public Accountants (AICPA), the Accounting Principles Board (APB), the Financial Accounting Standards Board (FASB), and other authoritative sources. Various state laws and regulations apply to CPA firms engaged in performing audits and reviews for business entities that will be used by third parties, such as banks and other financial institutions. Federal law also mandates certain standards which are administered through the U.S. Securities and Exchange Commission (SEC) in connection with publicly traded securities.

Earnings and profits (E&P). When a C corporation distributes dividends to shareholders, the shareholders are subject to income tax on the distribution. Dividends to shareholders are taxable to the extent they represent the C corporation's earnings and profits. E&P is not computed under tax rules, but rather, general accounting principles, although not necessarily under GAAP. IRS regulations state the following: "Due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing taxable income." The regulation goes on to state, "among the items entering into the computation of corporate earnings and profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61." (Reg. §1.312-6)

continued on page 27-17

State Secretaries of State Contact Information

State	Website	Phone Number	State	Website	Phone Number
Alabama	www.sos.alabama.gov	334-242-7200	Montana	www.sosmt.gov	406-444-3665
Alaska	www.commerce.alaska.gov	907-465-2550	Nebraska	www.sos.ne.gov	402-471-4079
Arizona	www.azsos.gov	602-542-6187	Nevada	www.nvsos.gov	775-684-5708
Arkansas	www.sos.arkansas.gov	888-233-0325	New Hampshire	https://sos.nh.gov	603-271-3246
California	www.sos.ca.gov	916-657-5448	New Jersey	www.state.nj.us/state	866-534-7789
Colorado	www.coloradosos.gov	303-894-2200	New Mexico	www.sos.state.nm.us	800-477-3632
Connecticut	https://portal.ct.gov/sots	860-509-6002	New York	www.dos.ny.gov	518-473-2492
Delaware	https://sos.delaware.gov	302-739-3073	North Carolina	www.sosnc.gov	919-814-5400
District of Columbia	www.os.dc.gov	202-727-6306	North Dakota	www.sos.nd.gov	800-352-0867
Florida	www.dos.myflorida.com	850-245-6000	Ohio	www.sos.state.oh.us	877-767-6446
Georgia	www.sos.ga.gov	404-656-2817	Oklahoma	www.sos.ok.gov	405-522-2520
Hawaii	www.cca.hawaii.gov/breg	808-586-2744	Oregon	https://sos.oregon.gov	503-986-2200
Idaho	www.sos.idaho.gov	208-334-2301	Pennsylvania	www.dos.pa.gov	717-787-1057
Illinois	www.ilsos.gov	800-252-8980	Rhode Island	www.sos.ri.gov	401-222-3040
Indiana	www.in.gov/sos	317-232-6531	South Carolina	www.sos.sc.gov	803-734-2158
Iowa	www.sos.iowa.gov	515-281-5204	South Dakota	www.sdsos.gov	605-773-4845
Kansas	www.kssos.org	785-296-4564	Tennessee	https://sos.tn.gov	615-741-2286
Kentucky	www.sos.ky.gov	502-564-3490	Texas	www.sos.state.tx.us	512-463-5555
Louisiana	www.sos.la.gov	225-925-4704	Utah	www.corporations.utah.gov	877-526-3994
Maine	www.maine.gov/sos	207-624-7736	Vermont	https://sos.vermont.gov	888-647-4582
Maryland	www.sos.maryland.gov	410-974-5521	Virginia	www.commonwealth.virginia.gov	804-786-2441
Massachusetts	www.sec.state.ma.us	617-727-9640	Washington	www.sos.wa.gov	360-725-0377
Michigan	www.michigan.gov/sos	888-767-6424	West Virginia	www.sos.wv.gov	866-767-8683
Minnesota	www.sos.state.mn.us	877-551-6767	Wisconsin	https://sos.wi.gov	608-266-8888
Mississippi	www.sos.ms.gov	601-359-1633	Wyoming	https://sos.wyo.gov	307-777-7311
Missouri	www.sos.mo.gov	573-751-4936			

Registering Patents, Trademarks, and Copyrights

Patents. *To register a patent, contact:*	Trademarks. *To register a trademark, contact:*	Copyrights. *To register a copyright, contact:*
www.uspto.gov/patents, 800-786-9199 Commissioner for Patents P.O. Box 1450, Alexandria, VA 22313-1450	www.uspto.gov/trademark Trademark submissions must be made electronically.	www.copyright.gov, 877-476-0778 Library of Congress, U.S. Copyright Office 101 Independence Avenue SE, Washington, D.C. 20559-6000

Book to Tax Adjustments—Schedule M-1

Note: The following information is intended for general use not covered under a regulated engagement. Accounting entries per books may vary depending upon the type of accounting engagement that is being performed.

Schedule M-1, *Reconciliation of Income (Loss) per Books With Income (Loss) per Return.* Examples of book to tax adjustments reportable on Schedule M-1 of Forms 1065, 1120, and 1120-S include (but are not limited to) the following.

Transaction	Per Books	Per Tax Return
Assets other than cash contributed to the business in exchange for an ownership interest.	Record as if the asset was sold to the business at FMV.	If it is a tax-free transfer, basis in the asset is the same as it was in the hands of the contributor at the time of transfer. If it is a taxable transfer, basis is generally equal to FMV.
Business Bad Debts	A business may estimate an allowance for uncollectible receivables based on prior experience and record these as bad debts. If a bad debt is later recovered, it is added to income.	Partly worthless bad debts are deductible when charged off the books. Totally worthless debts are deductible in the year they become totally worthless, even if it is not discovered until a later year. [IRC §166(a)]
Capital Losses	A loss on the sale of a capital asset should be recorded as such on the income statement, regardless of the size of the loss.	Net capital losses for C corporations are not allowed. Unused capital losses are carried back three years and forward up to five years. [IRC §1212(a)(1)]
Charitable Contributions	Expensed in full.	C corporation contributions are generally limited to 10% of taxable income. Unused contributions can be carried forward up to five years. [IRC §170(d)(2)(A)]
Computer Software	Depreciated over the estimated useful life of the software.	• 3-year SL depreciation for computer software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified. May also qualify for Section 179 deduction and special depreciation allowance. • 5-year depreciation if purchased with the computer and not separately stated. May also qualify for Section 179 deduction and special depreciation allowance. • 15-year SL amortization as Section 197 intangible if not available to general public and acquired in connection with purchase of business. • If useful life is one year or less, deduct as a current expense.
Depreciation	Generally the same as tax with the following exceptions: • C corporation E&P should use SL depreciation over ADS life. See *Alternative Depreciation System (ADS),* page 9-4. If Section 179 is elected for tax, use 5-year SL for E&P purposes. • Property contributed to the business in a tax-free exchange should be depreciated using the FMV of the property at the time of transfer.	• If property is contributed to the business in a tax-free exchange, continue the depreciation schedule under the same method used prior to the contribution as if the property had not been transferred. • If the property is contributed in a taxable exchange, basis for depreciation equals the FMV of the property at the time of the exchange, with the holding period beginning on the date of the transfer. See *Depreciation,* Tab 9.
Installment Sales	Under the accrual method of accounting, income is recognized when earned, even if payment is received in later periods. Deferral of gain under the installment method for purposes of a C corporation's E&P is not allowed, regardless of the taxpayer's accounting method. [IRC §312(n)(5)]	An installment sale is defined as a disposition of property where at least one payment is received after the close of the tax year in which the disposition occurs. Gain is recognized as payments are received, unless the taxpayer elects out of the installment method. (IRC §453)
Intangible Assets	An intangible asset is generally amortized over its estimated useful life. If it was internally developed and cannot be specifically identified, or does not have a determinable life, the cost is currently expensed as incurred.	The cost of self-created intangible assets is generally deductible as incurred. An intangible asset, such as goodwill, that is purchased from another business is amortized over 15 years, regardless of its estimated useful life. (IRC §197)
Leasehold Improvements	Amortize or depreciate the cost of the improvement over the shorter of the estimated useful life or the length of the remaining lease.	Leasehold improvements to nonresidential real property are subject to 15-yr or 39-yr SL depreciation. For more information, see *Qualified Improvement Property,* page 9-11.
Life Insurance	Generally expensed as incurred. Proceeds received are included in income.	Life insurance premiums are not deductible if paid on behalf of an owner, employee, or any person who has a financial interest in the business, and the business is directly or indirectly the beneficiary of the policy. Proceeds are not included in income.
Meals and Entertainment	Fully expensed as incurred.	• **Meals.** 100% deductible if provided by restaurant (2021 and 2022). 50% deductible for other meals. • **Entertainment.** Nondeductible.
Organizational and Start-Up Costs	Generally expensed as incurred since they generally do not have a determinable life.	Up to $5,000 for organizational costs and $5,000 for start-up costs is currently deductible. Phaseouts apply. The excess can be amortized over 15 years. See *Start-Up/Organizational Costs,* page 8-21.
Penalties and Fines	Expensed as incurred.	Not deductible.
Tax-Exempt Interest	Include in income.	Not taxable.

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Contributed Property Depreciation

Tax depreciation. Property contributed to a corporation in exchange for stock is a tax-free transaction if the rules under IRC section 351 apply. See *IRC Section 351—Nontaxable Transfers,* page 18-5. Property contributed to a partnership in exchange for a partnership interest is a tax-free transaction. For tax purposes, the partnership or corporation continues to depreciate the property under the same depreciation schedule using the same depreciation method and holding period as the contributing partner or shareholder immediately prior to the contribution. For the year of contribution, allocate the current year depreciation between the two businesses before and after the contribution.

Example #1: Denny is a self-employed drummer in a local wedding dance band. He purchased a new set of drums in June 2020 for $2,000. Denny elected out of bonus depreciation. His 2020 MACRS deduction is $286 ($2,000 × 14.29%), and his 2021 MACRS deduction is $490 ($2,000 × 24.49%). Assume on June 1, 2022, he contributes his drums to a newly formed S corporation in which Denny is the sole shareholder. Denny's Schedule C business deducts $175 ($2,000 × 17.49% × 50%) in 2022, and his S corporation deducts the other $175 for its 2022 MACRS depreciation. In 2023, Denny's S corporation continues to deduct the drums under the MACRS depreciation schedule for year number four.

Book depreciation. For bookkeeping purposes, the contributed property is treated by the partnership or corporation as a newly purchased property using the FMV at the time of the contribution as its cost basis for depreciation purposes. Two separate sets of depreciation schedules must be maintained to keep track of tax depreciation and book depreciation.

Example #2: Assume the same facts as Example #1, except that Denny's drums are worth $1,800 on June 1, 2022, when he contributes them to his S corporation in exchange for stock. For bookkeeping purposes, Denny's S corporation would start a new depreciation schedule for the drums beginning June 1, 2022, with a depreciable basis of $1,800.

Schedule M-1, *Reconciliation of Income (Loss) per Books With Income (Loss) per Return*

A corporation or partnership uses Schedule M-1 (Form 1120, 1120-S, or 1065) to reconcile its book income to the income reported on the tax return. Schedule M-1 starts with net income per books. The corporation or partnership then must make certain adjustments, referred to as M-1 adjustments, for book and tax differences to arrive at taxable income. Schedule M-1 should reconcile to taxable income as computed on:

- Form 1120, line 28, Taxable income before net operating loss deduction and special deductions,
- Form 1120-S, Schedule K, line 18, Income/(loss) reconciliation, or
- Form 1065, page 5, Analysis of Net Income (Loss), line 1, Net income (loss).

Generally, these adjustments fall into four categories.
1) Income subject to tax not recorded on the books,
2) Expenses recorded on the books not deductible for tax purposes,
3) Income recorded on the books not subject to tax, and
4) Expenses deducted on the tax return not recorded on the books.

Each item must be listed and described separately. Attach statement to the return as needed.

Income subject to tax not recorded on the books. Include income items that are accelerated for tax purposes due to a statu-tory provision or because of different conventions used for book accounting versus tax accounting, such as depreciation. Examples include:

- Installment sale income in years subsequent to the year of sale. See *Income recorded on the books not subject to tax,* below.
- Prepaid rent received.
- Prepaid interest received.
- Taxable gain on the sale of depreciable assets in excess of book gain.

Expenses recorded on the books not deductible for tax purposes. Include items that are not deductible for tax purposes or are deferred until some future event. Examples include:

- Federal income taxes.
- Book depreciation in excess of tax depreciation.
- Penalties and fines.
- Officers' life insurance premiums.
- Entertainment expenses. [IRC §274(a)]
- Entertainment-related meal expenses.
- Non-entertainment meal expenses not deductible because of the 50% limit.
- Expenses for the use of an entertainment facility.
- The part of business gifts over $25.
- Expenses of an individual over $2,000, which are allocable to conventions on cruise ships.
- Employee achievement awards over $400 ($1,600 if part of a qualified plan).
- The cost of skyboxes.
- The part of the cost of luxury water travel expenses not deductible to the extent that such expenses exceed twice the aggregate per diem amounts for days of such transportation. [IRC §274(m)]
- Expenses for travel as a form of education.
- Nondeductible club dues.
- Other nondeductible travel and entertainment expenses.

Income recorded on the books not subject to tax. Include items that are tax exempt or are temporarily deferred for tax purposes. Examples include:

- Tax-exempt interest.
- Gain on installment sales. Generally, the entire gain will be recorded on the books in the year of sale, while the taxable gain is spread out over multiple years.

Expenses deducted on the tax return not recorded on the books. Include deductible items that are accelerated for tax purposes due to a statutory provision or because of different conventions used for book accounting versus tax accounting. Examples include:

- Tax depreciation in excess of book depreciation.
- Expenses accrued in a prior year but deductible in the current year.

Net Income (Loss) Reconciliation—Schedule M-3

Certain domestic corporations and partnerships are required to file Schedule M-3 (Form 1120, 1120-S, or 1065) in place of Schedule M-1. Schedule M-3 requires companies to provide a more detailed reconciliation between financial statement net income and taxable income than Schedule M-1, and therefore allows the IRS to more easily identify compliance irregularities.

There are separate, unique Schedules M-3 for different entities.

- Form 1120 – *Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More.*
- Form 1120-S – *Net Income (Loss) Reconciliation for S Corporations With Total Assets of $10 Million or More.*
- Form 1065 – *Net Income (Loss) Reconciliation for Certain Partnerships.*

Required filers. Schedule M-3 replaces Schedule M-1 in the following situations.

C corporations. Any domestic corporation, or group of corporations, required to file Form 1120, *U.S. Corporation Income Tax Return,* that reports total assets of $10 million or more at the end of its tax year must file Schedule M-3 (Form 1120). This includes consolidated tax groups as well as cooperatives that file Form 1120-C, *U.S. Income Tax Return for Cooperative Associations.*

S corporations. Any entity required to file Form 1120-S, *U.S. Income Tax Return for an S Corporation,* that reports total assets $10 million or more at the end of its tax year must file Schedule M-3 (Form 1120-S).

Partnerships. Any entity that files Form 1065, *U.S. Return of Partnership Income,* must file Schedule M-3 (Form 1065) if it has:
- Total assets of $10 million or more at the end of the year,
- Adjusted total assets for the tax year of $10 million or more,
- Total receipts for the tax year of $35 million or more, or
- A reportable entity partner that owns 50% or more of the partnership's capital, profit, or loss, on any day during the partnership's tax year.

Adjusted total assets. For the purposes of determining the partnership's adjusted total assets, the partnership's total assets at the end of the tax year must be determined on an overall accrual method of accounting unless both of the following apply.
- The tax return of the partnership is prepared using an overall cash method of accounting, and
- The partnership does not prepare financial statements using, and is not included in financial statements prepared on, an accrual basis.

Reportable entity partner. A reportable entity partner is:
- An entity that owns or is deemed to own, directly or indirectly, a 50% or greater interest in the income, loss, or capital of the partnership on any day of the tax year, and
- An entity that was required to file Schedule M-3 on its most recently filed U.S. federal income tax return.

Schedule M-3 effect on Schedule L. If a non-tax-basis income statement and related non-tax-basis balance sheet is prepared for any purpose for a period ending with or within the tax year, Schedule L (Form 1120, 1120-S, or 1065) must be prepared showing non-tax-basis amounts.

The entity's assets may not be netted or reduced by the entity's liabilities when measuring total assets at the end of the year.

Completing Schedule M-3. Schedule M-3, Part I, asks questions about the entity's financial statements, including whether they were prepared according to GAAP or some other non-tax-basis accounting system.

Schedule M-3, Parts II and III, reconcile financial statement income (loss) for the entity (or consolidated group) to taxable net income on Form 1120, 1120-S, or 1065. Differences must be classified as temporary or permanent.

Schedule M-3 required filers that have at least $50 million total assets at the end of the tax year must complete the entire schedule.

Schedule M-3 required filers that have less that $50 million total assets at the end of the tax year, or are not required to file but are doing so voluntarily, may either:
- Complete Schedule M-3 entirely, or
- Complete Schedule M-3 through part I, and complete Schedule M-1 instead of completing parts II and III of Schedule M-3. Line 1 of Schedule M-1 must equal line 11 of Schedule M-3, Part I.

Parts II and III general information. Schedule M-3, Parts II and III are divided into four columns.

a) Income (loss) or expense per income statement.
b) Temporary (timing) difference.
c) Permanent difference.
d) Income (loss) or deduction per tax return

For any item of income, gain, loss, expense, or deduction for which there is a difference between columns (a) and (d), the portion of the difference that is temporary must be entered in column (b) and the portion of the difference that is permanent must be entered in column (c).

If financial statements are prepared by the entity under generally accepted accounting principles (GAAP), differences that are treated as temporary under GAAP must be reported in column (b) and differences that are permanent (that is, not temporary) for GAAP must be reported in column (c). Generally, under GAAP, a temporary difference affects a deferred tax asset or liability.

If the corporation does not prepare financial statements, or the financial statements are not prepared under GAAP, report in column (b) any difference that the corporation believes will reverse in a future tax year or is the reversal of such a difference that arose in a prior tax year. Report in column (c) any difference that the corporation believes will not reverse in a future tax year, and is not the reversal of such a difference that arose in a prior tax year. If the corporation is unable to determine whether a difference between column (a) and column (d) for an item will reverse in a future tax year or is the reversal of a difference that arose in a prior tax year, report the difference for that item in column (c).

Part II, Schedule M-3, *Reconciliation of Net Income (Loss) per Income Statement With Income (Loss) per Return.*

Column a, Income (Loss) per Income Statement. This is the financial statement income found in the source document described in Part I. Total should match, Part I, line 11.

Column b, Temporary Difference. This includes any difference the entity believes will reverse in a future year. It includes:
- Income recognized in the financial statements before it is taxable, such as gain on a current year installment sale, and
- Income reported as taxable before it is recorded in the financial statements, such as prepaid rent or interest received.

Column c, Permanent Difference. This includes differences that will not reverse in a future year, such as tax-exempt interest.

Column d, Income (Loss) per Tax Return. Total of column a) plus or minus columns b) and c). Totals should match taxable income (Form 1120) or net income (loss) (Forms 1120-S or 1065).

Part III, Schedule M-3, *Reconciliation of Net Income (Loss) per Income Statement With Income (Loss) per Return—Expense/ Deduction Items.*

Column a, Expense per Income Statement. This is the financial statement expense as shown on the entity's books using the source document described in Part I.

Column b, Temporary Difference. This includes any difference the entity believes will reverse in a future year. It includes:
- Expenses recorded on the books not deductible for tax purposes, such as book depreciation in excess of tax depreciation, and
- Expenses deductible on the tax return before they are recorded in on the books, such as tax depreciation in excess of book depreciation.

Column c, Permanent Difference. This includes differences that will not reverse in a future year, such penalties and fines.

Column d. Total of column a) plus or minus columns b) and c). Totals flow through to Part II.

Annual determination. The Schedule M-3 filing requirement is determined separately each tax year. Thus, a corporation or partnership may not be required to file Schedule M-3 every year.

A corporation or partnership that is not required to file Schedule M-3 may voluntarily file Schedule M-3 instead of Schedule M-1.

Penalties. While there are no stated penalties for failing to file Schedule M-3 when required, all penalties applicable to Forms 1120, 1120-S, or 1065 apply also to Schedule M-3.

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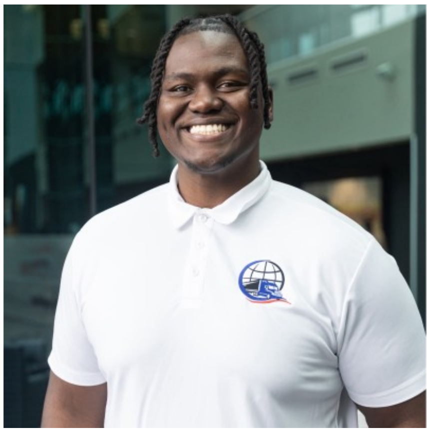

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