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Tax Planning Opportunities for Cash Basis Professional Service Firms

ANOTHER TAX DEADLINE HAS PASSED. Are you satisfied with the amount received or the balance due on your tax returns?

Tax planning is a forecast, not a retroactive act. It's difficult to pay a minimal tax bill if you haven't monitored your tax situation throughout the year. Proper tax planning is accomplished when all factors that may impact a company over the course of the year are analyzed. It is not too early to start tax planning, especially for firms using the cash basis method of accounting.

The majority of professional service firms use the cash basis method of accounting for tax reporting rather than the accrual method. The accrual method reports income when earned and expenses when incurred; the cash method reports income when received and expenses when paid. The ability to defer income and accelerate expenses creates significant tax deferral opportunities for those using the cash method. Proper tax planning helps firms capitalize on this opportunity and minimize taxation.

Tax planning opportunities for cash basis professional service companies are highlighted below:

1. Deductibility of regular and prepaid expenses

Business expenses are deductible if they are ordinary, necessary and directly related to the business. Capital expenditures for significant purchases are required to be depreciated over the life of the asset. Recovery of the depreciation expense can be accelerated by utilizing the Internal Revenue Code Section 179, which allows significant depreciation of the asset in the first year of service.

Deductibility of prepaid expenses is subject to special rules. Prepaid expenses can only be deducted if the benefit does not extend beyond the earlier of 12 months after the first date the taxpayer realizes the benefit, or, the tax year following the payment. For example, a business cannot take a tax deduction for a two-year lease payment paid in one lump sum. Only 12 months worth of lease payments are allowed for tax purposes in the current year. The balance is then allocated to prepaid expenses and deducted in the following year.

Credit card purchases are treated like cash payments. They provide the opportunity to record the expense and delay the cash payment if cash flow is limited.

2. Deferral of invoicing and collections

Cash basis businesses can delay an invoice so payment is not received until the following year. However, if you receive payments and do not deposit them, they are still considered cash received for cash basis purposes.

3. Pension and profit sharing plan deductions

Pension and profit sharing plans provide another way for employers to minimize tax and give an incentive to their most important asset - employees. Employer plans create employee incentives through 401(k) matching and additional discretionary contributions. Knowing your firm's plans is important prior to year-end planning. If amendments are necessary, preliminary reviews allow more time to make necessary changes for optimum tax planning.

4. Tax credits/deductions, financing incentives and entity structure

Economic Opportunity Area Credits, grants, employment credits and other tax incentives can play a significant role in reducing your tax burden. A certified public accountant can help identify those tax incentives. In addition, the type of entity structure for your business plays a significant role in tax planning. Annual evaluation of your current structure is important in your tax planning process.

5. Alignment of tax strategies to business goals

Above all, tax planning must align with your long-term business plan. Depletion of cash to create deductions is not always the right choice. If your desire is to build funds for future business endeavors, tax planning may help you identify noncash deductions (depreciation) and utilize tax credits allowing the firm to increase cash funds for future investments.