Daniel M. Isard

Re-Engineering Your Tax Planning

I must walk a fine line as a columnist for *The Director*. On one hand, I want to educate you, the reader, in order to help you become a better business operator. On the other hand, I want to help you avoid doing tempting but silly things that can hurt your business. The challenge I face is to do both while not interjecting personal politics. Unfortunately, this is nearly impossible when discussing the subject of income tax.

Therefore, as you read this month's column, please assume that when it comes to the motivations I ascribe to the various political parties and sub-parties, I am an "equal-opportunity abuser." Moreover, I believe that no enlightened person can explain income tax planning without making sure his or her audience first understands the history of income tax.

History and Purpose of Income Tax

The history of income taxation in the United States is complex. Most taxes in this country during its first 100 years dealt with tariffs – a tax on the use or importation of specific products. That famous tea party in Boston Harbor, for instance, was about a tariff, not an income tax. In fact, this country's Founding Fathers never mentioned or even thought about taxing income.

The federal government didn't levy an income tax until 1861, during the Civil War. It was unpopular and modified a few times until the first peacetime income tax was established in 1894. Because of the latter's low tax threshold ($4,000 annually), however, this income tax didn't affect most Americans.

It wasn't until Congress ratified the 16th Amendment in 1913 that income taxation permanently started. That amendment states: *The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.*

Our first federal income tax was simple enough: 1 percent on all income above $3,000 and 7 percent on income above $500,000. At that time, few people objected because few earned more than $3,000 per year. Like any addict, however, once you're hooked, you need more. Thus, within four years, Congress increased the top taxation rate to 67 percent on income over $2 million!

And Congress didn't stop there. In 1944, during World War II, it raised the income tax to 94 percent on the top-tier income bracket. During the 1960s, the top rate dropped to 70 percent before President Ronald Reagan brought it down to 28 percent in 1988. The Clinton administration raised it back up to 39.6 percent, and President George W. Bush brought it back down to 35 percent.

Admittedly, the preceding doesn't offer a comprehensive historical understanding of the U.S. income tax system, but regardless of the rate, the purpose of taxation in this country has always had the same fourfold purpose:

1. To raise money with which to run the government
2. To provide a source of funds for redistribution to support the public good
3. To stimulate the economy
4. To discourage certain actions.

The first purpose is easy to understand, and the second deals with collecting taxes

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to provide for the disenfranchised. President Kennedy once said, "The 90 percent must take care of the 10 percent." (When I was very young, I learned this quote by heart because one of my uncles served as Kennedy's chief economic advisor on domestic matters.)

The third and fourth points are yin-and-yang purposes. For example, the government can issue tax breaks that encourage people to buy cars, which boosts the auto industry. The flip side, however, occurs when the government does *not* offer tax incentives for automobile purchases, which therefore discourages this behavior. So, some things are encouraged and therefore deductible and some spending is not encouraged and therefore is not deductible.

What Is Income?

Now that you understand the general history of income taxes, let's look at what the 16th Amendment considers "incomes from whatever source derived." You pay taxes on income, which is defined as "the amount you are paid as salary, as well as the earnings on your invested principal." So, if your business generates gross revenue of $1 million, you are *not* taxed on that. Income is the *net* amount of revenue left after you pay all of the deductible expenses incurred while running your business.

Not all of the expenses you incur when running a business are deductible. Expenses involving tangible equipment for your business are considered investments and therefore "depreciate" over time. Some business investments involve intangible purchases, which are "amortized" over time. Still other expenses are simply non-deductible, meaning you can neither depreciate nor amortize these amounts.

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Tax-planning Basics

Tax planning is not illegal. In 1934, Judge Billings Learned Hand of the U.S. Court of Appeals ruled: *Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the Treasury. There is not even a patriotic duty to increase one's taxes. Over and over again, the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike, and all do right, for nobody owes any public duty to pay more than the law demands.*

Given that premise, here's why you should plan to pay the amount of income tax *you* want to pay.

As a business owner, your first tax-planning step involves choosing whether your business pays taxes on its earnings at the business tax rate or the individual tax rate. If you want your business to pay the business tax rate, then you need to organize as a C corporation, which currently features these tax rate brackets:

- 15 percent on the first $50,000 of taxable corporate income, plus
- 25 percent on the next $25,000 of taxable corporate income, plus
- 34 percent on the next $25,000 of taxable corporate income, plus
- 39 percent thereafter (unless yours is a really large corporation).

This essentially means that if you op-

erate as a C corporation and your business earns $100,000, your income tax will be $22,250.

Paying income tax at the individual tax rate (the second option above) offers more choices. You could be unincorporated as a partnership or as a sole proprietorship. You could operate as an LLC or a Sub S corporation. These earnings are taxed as additional income of the shareholders based on their percentage of ownership. So, under the individual tax rate, if you took a reasonable salary out of your company and had the same $100,000 of earnings as the C corporation in this example, your tax would be about $39,000 on that business income.

Cash or Accrual Method?

Earlier, I defined income and deduction, but I didn't define revenue, which is the first step when computing your taxable income. Most funeral home owners can choose how to define revenue, which can be either:

1. "That which you have the right to collect from a family" (this is the accrual method of income recognition)

2. "That which you have collected from a family" (this is the cash method of income recognition).

Prior to 2001, you could only use the accrual method for tax filing, but since 2001, most funeral homes can use the cash basis. Here is the difference: Suppose a family comes in on December 31 and arranges a $10,000 funeral but doesn't pay you until January 3. If you use the accrual method of income recognition, you have $10,000 of revenue. If you use the cash method, however, you have $0 revenue for that tax year.

Funeral service incurs lots of receivables, and most small funeral homes probably have larger receivables than the entire McDonald's Corp.! This is because most of you extend credit while McDonald's requires full payment for every hamburger at the time of sale. ✶

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