FINANCE 101

TAX PREPARATION

CASH / ACCRUAL METHODS

By Daniel M. Isard

A Cautionary Tale

Tax planning is legal. Tax fraud is not.

Dear Dan,
I've read your articles my entire professional career. I'm writing now in hopes that you can help me. I used to think tax planning was easy. If I had a good year, I didn't open envelopes with payments in them for the last two weeks of the year and paid all of my expenses. Therefore, by December 31, revenue was down and expenses were up. I would then deposit the payments in early January so they'd be next year's problem.

If the following year was good, I stopped opening envelopes the first week of December and paid all bills. When I started this planning process about seven years ago, it seemed like a smart idea. Unfortunately, we've grown. Now I don't open envelopes any time after September!

Today I received a dark brown envelope, sent return receipt requested, from the local IRS office. They are auditing my 2014 tax return. Why would they audit this year and not the others? What can I do? All of a sudden, I don't feel so confident with my tax planning idea.

Having a Heart A Tax in Truro

Dear Heart A Tax,
Yes, you and a bunch of other people assume that a tax return is an approximation of the amount of tax you have to pay. No! Tax preparation is serious business. Your idea of not opening up the checks is flawed on two levels: the catch-up in future years and accrual-based accounting.

Allow me to do a few things in this article. First, let me explain how deep in the IRS webbing you are. Second, let me not give you any hope of getting out. Third, let me use your letter to scare the stuffing out of other like-minded funeral home owners. And fourth, allow me to have some fun at your expense.

I'm sure that when you're in federal lockup with the likes of Wesley Snipes, Martha Stewart, Willie Nelson and others, you can have a good laugh reading this article to your cellmates (check off #4 on the list).

One thing you could try is converting to Judaism. You'll find that the food is much better and the environment safer in the kosher penitentiaries within the federal prison system (I know, another checkmark for #4).

Why didn't a scheme as well thought-out as yours work? Well, my future stripe-wearing felon, as you know, your scheme focuses on deferred recognition of revenue. Your scheme might have worked, except for two things. First, your business kept growing. If you were incompetent and the business was dropping off instead, then you could have deferred income into the next year and maybe gotten away with it.

As for the second issue, I don't know where Truro is, but if it's part of the United States, you are accorded only two methods of recognizing income and expenses: the cash method and the accrual method.

Using the accrual method, you recognize revenue when you have the right to receive it. This is the method that more than 98% of all funeral homes use. Thus, it doesn't matter when you open those envelopes because you are taxed as if you received the income when you made the funeral arrangements. Simply, in the accrual method of taxation, you recognize income and expense when you accrue the income or expense.

As Judge Learned Hand said in his ruling on the constitutionality of tax planning: "For nobody owes any public duty to pay more than the law demands." That ruling goes back more than 80 years, and the outcome is as simple today as it was then.

Tax planning is legal; tax fraud is not. When you file your tax return, you do so under "penalty of perjury." The normal statute of limitations is three years from the date the tax return is filed. If you filed a false or fraudulent return, however, there is no statute of limitations as the statute only begins when a legitimate tax return is filed.

The time line doesn't end when the IRS can establish that a taxpayer has either filed a false or fraudulent return, willfully attempted to evade the tax due or failed to file a return at all. This is not the same as someone who errors in the interpretation of a tax code or makes a math error. If the taxpayer is willful or intentional in not filing taxes or is filing fraudulent returns, not only will there be no time limit on IRS action, there will also be heightened interest, fees and penalties.

Even worse, tax fraud and evasion are criminal violations. Offenders face the prospect of fines and jail time if the government seeks to prosecute. Not only is there a risk to your freedom but imagine for a moment the printed headlines of your local newspaper, "Truro Funeral Director Arrested for Tax Evasion." Do you think that will be good for business?

I hope I have both scared you and educated you. Now I want to inform you. Tax planning is possible.

Even before you did some tax planning, assume you made $100,000 as a Sub S, an LLC or some entity other than a C Corporation. Your federal tax will be about $39,000 at most, which means that even after paying the tax, you keep $61,000 or 61% of your profit. Any tax planning you do will focus on reducing the 39% the government would get.

If you were a C Corporation, that tax would be 22.5% on the first $100,000 of earnings, which means you live in a 78.5% tax-free world. Why would someone risk imprisonment for a small tax price such as this?

If you really want to save money, don't go out and buy new cars or machinery unless you really need the new assets. At best, these items can only reduce your tax by the above percentages. Why would you spend $1 to save 39 cents? It makes no sense to me. I do love the tax planning advantages of retirement plans, but that is too complex a subject to write about in the space of this column.

In short, a retirement plan allows you to take currently taxed income, put it away, invest it, allow it to compound tax free and take it out in the future when, hopefully, you're in a lower tax bracket. Is this perfect? No.

If you have other employees, you will need to include them in the plan. If a well-informed retirement plan counselor can design a plan for you that has less than 39% of the total contribution going to the other employees, then it is better to fund a retirement plan than buy unwanted assets.

I tend to be a stickler about tax planning. I'm not some goody two shoes, but I will work within the rules to save or defer tax money. The best technique starts with recognition of income and expenses. I like the cash basis recognition for taxation (not for management purposes). Our accounting team uses accrual for management planning but cash basis for tax filing. In the days before computers, that would have been a nightmare, but today, all it takes is flipping one switch in the setup page.

Tax planning requires tax-forward thinking. A typical accountant is like a fortune teller who doesn't look ahead, so find yourself an accountant who is progressive enough to plan in advance.

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