

WRENCHES TO WRITE-OFFS

*Tax Tips Every Repair
Shop Owner Should Know*



HUNT DEMAREST, CPA/ABV

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Shop Owner Should Know*

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Wrenches to Write-offs: Tax Tips Every Repair Shop Owner Should Know

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Paperback: 979-8-9895758-2-4

Dedicated to Dennis, the best friend I could ever ask for.



PREFACE

I personally believe that understanding the basics of taxes and how your decisions impact your tax situation is pivotal for excelling as a shop owner. This doesn't mean you should handle your own taxes – in fact, quite the opposite. However, having a solid grasp of the basics is essential to asking the right questions when consulting your accountant. Our primary focus is on understanding our clients' expectations and crafting plans that align perfectly with their goals.

The motivation behind writing this book was to shed light on major strategies, tactics, and common questions that arise from shop owners surrounding taxes. These topics have all been previously featured on my podcast, "Business by the Numbers," and have been repurposed to serve as a guide to help you navigate the ever-evolving world of taxes. While not all the strategies may be applicable to you now, having this knowledge background may offer you more clarity and potential cost savings down the road!

A handwritten signature in black ink, appearing to read "Hunt Demarest", with a long horizontal line extending to the right.

Hunt Demarest, CPA/ABV

“It's not about how much money you make, but how much you keep, how hard it works for you, and how many generations you keep it for.”

– Robert Kiyosaki

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Glossary

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1

Effective Tax Planning

The Relationship Between Earnings and Taxes

When people talk about increasing their income, they often don't consider the tax headaches that come along with it. Before delving into strategies to reduce tax, it's important to understand your tax liabilities. It's a common misconception that more income always means more tax. But understanding the ins and outs of your earnings and tax liabilities ensures you're not planning for benefits that might not be as lucrative as you thought.

The Tax Planning Process: Our Approach

At our firm, there isn't a one-size-fits-all approach to tax planning. Here's a brief overview of our method of operation:

Consistent Monitoring: Tax planning is a continuous process, not a one-time event. The unpredictable nature of businesses, especially cyclical ones like the auto repair industry, makes constant vigilance imperative.

Initial Phase: Our first interaction with tax planning often coincides with your annual tax return. This phase sets the tone for the financial year ahead.

Mid-Year Review: After the first six months, our analysis of the year-to-date financials paves the way for future financial forecasting.

End of Year Projections: By the close of the year, we consolidate our findings, observing the ebbs and flows of your finances, to refine our tax strategy for you.

Estimated Tax Payments

Estimated tax payments can be a source of worry for many shop owners. Typically, our clients, particularly those running S corporations, partnerships, or functioning as sole proprietors, have two primary methods to handle these:

1. *Payroll Withholding*: Some clients find it easier to manage their estimated tax through increased withholding in their paychecks.
2. *Quarterly Estimates*: This involves making four payments to the government throughout the fiscal year, spreading out the tax liability.

Why not delay these payments until year-end? Understanding why the government wants its money spread throughout the year, rather than at the end, is essential. It's partly to ensure consistent cash flow and partly to accommodate taxpayers who might find it challenging to produce a lump sum at year's end.

Smart Tax Management for Shop Owners

Many of us entrust our finances to accountants. If you do, it's essential to routinely ask them about your financial status to make sure you avoid underpayment penalties. My take on whether or not to pay these penalties? Well, it really depends on the client.

Some clients wisely manage their finances, budgeting diligently. To them, I'd say, "You owe 40k, but you only need to deposit 20k now. Set aside the rest for the upcoming tax period." But if you're the type to impulsively spend, paying upfront might be smarter.

The irony is many of the people who complain about offering the government a "tax-free loan" keep idle

money in a non-interest-bearing checking account. If you owe the money, why not clear the slate?

Taxes are a grudge payment for most. But, why not understand the strategies to minimize them?

Though not exhaustive, a few strategies especially beneficial for auto repair shops include handling large purchases like equipment or vehicles. But don't buy just for tax breaks. It's most important to ensure every purchase is a smart business decision.

The Three Fundamental Questions:

1. *Will it increase profits?*
2. *Will it make tasks more efficient or life easier?*
3. *Were you planning to buy it soon anyway?*

Ask yourself these questions when considering a large purchase. If a new AC machine costs \$5,000 and will introduce a profitable service, it's a sound investment. Plus, it could provide around \$1,250 in tax savings. However, don't splurge on equipment like a new tire machine merely for the tax break. Spending \$10,000 might save \$2,500 in taxes, but if the equipment isn't necessary, you're still down by \$7,500.

Consider equipment that, while not directly profitable, can make tasks easier and improve technician morale.

A faster, user-friendly alignment machine might encourage technicians to recommend more alignments, in turn driving sales.

Vehicles, especially trucks and large SUVs exceeding 6,000 lbs, can offer considerable first-year tax write-offs as well.

For more information, check out Chapter 7 – Handling Big Purchases, on page 59.

The Best Strategy? Retirement Accounts!

My top recommendation for tax savings is funding retirement accounts. When individuals complain about their high taxes and ask about wealthy folks' strategies, I steer them towards their retirement contributions.

For instance, with a 401(k), if you invest \$10,000, not only does this remain your money (albeit locked away for a time), it also yields about \$2,500 in tax savings. Unlike other tax-saving methods, here, your money still belongs to you.

Read more about retirement accounts in Chapter 10 – The Single Best Tax Deduction, on page 83.

OTHER TAX SAVING STRATEGIES

Reward Your Team



While everyone likes cash, it could increase taxes



Reimburse Them for Tools



Full deduction for the business and not taxable for the employee



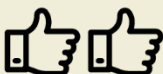
End of Year Celebrations



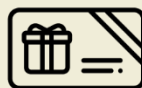
Not only does it boost morale, but it's tax-deductible for the business and isn't taxable for your employees



Gift Cards



Tax-deductible for the business and not considered reportable income for the recipients



Entity Selection: Finding the Right Fit

The legal structure of your business has a significant influence on taxes. While this might seem complex, it's critical.

It's essential to periodically assess if your existing structure, be it a Schedule C, sole proprietorship, or C corporation, is still the most tax efficient. Often, shifting to an S corporation can save you substantially.

Many businesses are converting from C corporations to S corporations, purely for tax benefits. It's about saving without unnecessary spending.

For more information on entities, read Chapter 3 – Entity Choices, on page 21.

Adjusting Payroll and Draws: Finding the Right Balance

Pay attention to how you're drawing your salary. If you're an S corporation, keep an eye on not overspending on payroll, thereby accruing unnecessary payroll taxes. You can save a lot on taxes by tweaking payroll and distributions wisely.

Timing is everything. Most tax strategies need proactive implementation. Once the year ends, it's challenging to change things retroactively. Avoiding

future regret means planning and acting ahead of time.

To learn more about owner's draws, check out Chapter 4 – Owner's Distributions and Taxation, on page 30.

Missteps in Tax Minimization

While strategic planning is essential, some common misconceptions can lead to mistakes:

Buying Real Estate: While it can be a good business move, it's not necessarily a great tax deduction due to depreciation rules.

Expanding Existing Infrastructure: Expanding your current business space might seem like a substantial deduction, but the tax implications may not always be favorable.

Boosting Your Payroll: Increasing your salary or awarding yourself a bonus might seem enticing but can result in a higher tax liability.

Expensive Car Purchases: If you're thinking about buying a luxury car for a tax break, think again. There are limits to how much you can deduct in the first year.

Unnecessary Purchases: Avoid buying equipment or assets you don't need just for tax breaks. This approach could hurt more than it helps.

Bottom Line

While taxes are a part of doing business, surprises shouldn't be. The objective isn't necessarily to have a zero-tax liability but to have a predictable and minimized one. Aim to owe taxes - because that means your business is profitable. However, be sure you're only paying what's due and not a penny more. Remember to consult with your accountant regularly and ensure you're on the same page. Your business deserves a strategic approach to tax planning.

2

Navigating Tax Season: Expert Insights and Advice

Tax season is a period often met with dread and stress for many. This chapter dives deep into some commonly asked questions during this time and offers essential insights for better tax management.

Embracing Inquisitiveness

One fundamental piece of advice? Always ask questions! Understanding the intricacies of your tax

return can empower you to manage your business more efficiently. So, put aside the fear of 'bothering' your accountant. When it comes to taxes, which can get pretty complex, every question matters.

Tax planning is like fine-tuning a high-performance engine. Future projections, potential deductions, and the necessity of certain claims all play a role. For instance, if a business has already reported a loss for the year, seeking further depreciation may not be prudent. Instead, it's more beneficial to keep it for subsequent years when it can be better utilized.

Further complicating matters are fluctuating annual incomes. If a shop owner generally earns \$200,000 annually, they fall into a higher tax bracket than if they made \$100,000. In a year where earnings dip, it may not be beneficial to claim extra deductions. Saving them for more prosperous times when they can counteract higher tax rates is smarter.

Understanding tax brackets is essential. Often misconstrued, moving into a higher tax bracket doesn't mean all your income is taxed at the elevated rate, but rather only the portion that exceeds the threshold. For instance, surpassing the \$525,000 bracket by a few thousand only subjects the excess to the highest tax rate.

Should I Get an Extension?

A point of contention for many taxpayers is the concept of tax extensions. There are two types of extensions: Business extensions and Personal extensions.

While some taxpayers ardently want their taxes filed as soon as possible, others lean towards the extension. The reasons can vary, ranging from the need for timely completion to simple procrastination. However, it's important to understand the rationale behind extensions.

➔ *Business Extensions*

Businesses, specifically S corporations and partnerships, have their taxes due on March 15th. These deadlines are set up to make sure K-1 forms get sent out smoothly. This form reports the distribution of income, deductions, and credits to the partners or shareholders.

Many businesses opt for extensions due to the intricacies involved. These extensions might seem unnecessary, but they play a pivotal role in financial strategizing, especially concerning depreciation considerations.

➔ *Personal Extensions*

The deadline for personal taxes is April 15th. But what does extending mean for an individual

taxpayer? Primarily, it means that while you get extra time to file, you don't get extra time to pay. Understanding this distinction can save you from unexpected penalties.

Depreciation: Navigating the Value Highway

One recurring term in the world of taxes is 'depreciation.' The idea of writing off substantial expenses like equipment can be enticing. However, a strategic approach is needed. Here's where concepts like the Section 179 expense or bonus depreciation come into play.

| Section 179 | VS | Bonus Depreciation |
|--|----|---|
| <ul style="list-style-type: none"> ➤ Allows you to deduct a set dollar amount. ➤ Qualifying Assets: <ul style="list-style-type: none"> - Tangible property (building, equipment, etc.) - Leasehold improvements (repairs or changes made to building or property) ➤ Cannot be larger than your annual business income ➤ More flexibility | | <ul style="list-style-type: none"> ➤ Allows you to deduct a % of an asset's cost upfront. ➤ Qualifying Assets: <ul style="list-style-type: none"> - New or used property (not land or buildings) with a useful life of 20 years or less ➤ No income limitations ➤ For 2023, only 80% can be deducted (will decrease each year) |

Should you take the entire deduction in the year of the purchase, or spread it out over several years? This choice can significantly impact your financial strategy. Immediate deductions can be tempting but might not always be the wisest course of action.

Navigating the complexities of accelerated depreciation can seem daunting, but understanding its intricacies is critical, especially for those invested in vehicles or real estate.

Vehicle Accelerated Depreciation

Vehicles have been at the forefront of discussion for accelerated depreciation. The type and weight of the vehicle plays a pivotal role.

The Significance of Size and GVWR: It isn't merely about whether the vehicle is large or whether it's labeled a 3500 or an F-150. The underlying factor is the Gross Vehicle Weight Rating (GVWR). Vehicles with a GVWR of 6,000 pounds or above can have their entire cost written off in the first year. Anything below this weight has limitations.

Interpreting GVWR: This doesn't denote the actual vehicle weight but its capacity inclusive of passengers, cargo, and the like. Many manufacturers, cognizant of this limit, produce vehicles like the Jeep Grand Cherokee with a GVWR just over this limit (6,001 pounds). Typically, full-size SUVs like the Ford Explorer or the Chevy Tahoe will qualify.

Before purchasing, verify the vehicle's GVWR. While dealerships might provide this, cross-referencing online is recommended. For instance, certain hybrids weigh more due to batteries, affecting their GVWR. Being precise matters.

Want to opt for a smaller vehicle? Smaller SUVs, crossovers, or sedans can still be depreciated, albeit with a ceiling. The first-year depreciation is capped at \$18,000, and any excess is spread over the next four years. An illustrative comparison: A \$120,000 BMW 7 series offers a first-year deduction of \$18,000, while a Mercedes G Class SUV of the same price can be entirely written off. This disparity makes SUVs and trucks more popular for business deductions.

Leasehold Improvements and Accelerated Depreciation

Real estate, especially with respect to leasehold improvements, is another area that has seen shifts in depreciation rules.

Pre-2018, depreciation rules for leasehold improvements were stringent. For instance, a \$200 toilet in a commercial building would be depreciated over 39 years. But post-2018, "qualified leasehold improvements" were introduced, allowing full cost write-offs in the first year.

Criteria for Accelerated Depreciation: Generally, if the modification doesn't expand the existing building

footprint, it qualifies. Typical examples include roofing, flooring, and interior remodeling. Conversely, extensions or additions that enlarge the footprint won't qualify for accelerated depreciation.

Imagine a shop owner who spends \$100,000 on a new roof. Traditionally, the cost would be spread out over 39 years for depreciation purposes. However, now the owner has the option to claim the entire cost as a deduction in the first year itself. This decision should be carefully considered, especially when comparing assets with different depreciation spans. For instance, it might make sense to claim the entire cost of a long-lived asset like a roof immediately, while the cost of a shorter-lived asset like a vehicle might be spread over a few years.

Though it might be tempting to claim deductions right away for immediate tax relief, it's essential to consider the future financial needs of the business and plan strategically. Evaluating the long-term financial implications will help in making informed decisions regarding depreciation claims.

Exploring Accelerated Depreciation Through the Tax Code

Stepping into the world of financial decisions can feel like navigating a maze, especially when you're trying to figure out if accelerated depreciation is the way to go. There are two big things that really need our focus.

First, the method of purchase is important – was the asset purchased in cash or was it financed? Consider the scenario above of the new \$100,000 roof. If you acquired a loan for this roof and committed to financing it over a decade, it's tempting to deduct the entire cost in the first year. The catch, however, is that while you get an immediate \$100,000 deduction, you're saddled with the loan repayment for the next nine years. During this period, your profits are primarily directed to service the loan, with minimal deductions to cushion the impact.

Similarly, the nuances of leasing equipment, particularly lease-to-own arrangements, bring about their considerations. It's not rare to see folks drowning in debt without any tax deductions to ease the pain. It's a scenario that calls for a good hard look before diving in. If a business already owes a significant amount, adding accelerated depreciation might not always be the right call. Conversely, if an upfront cash payment was made for the asset, a strong case can be made for claiming the entire cost in the first year.

For more information on vehicle depreciation, see Chapter 7 – Handling Big Purchases, on page 59.

Capital gains, or profits from asset sales, have their tax intricacies. They fall into short-term (held less

than a year) or long-term (held for over a year) categories. The former is taxed like regular income, while the latter enjoys a more favorable rate. This distinction often guides investment strategies, as holding onto an asset for over a year can result in significant tax savings.

Lastly, let's touch upon distributions – the portion of profits business owners can allocate to themselves. Often, I am questioned about the tax implications of these distributions. The rule of thumb is that distributions aren't taxed directly. However, the profit that allows for these distributions is. So, whether you decide to reinvest or distribute your profits, the tax liability remains tied to the profit amount.

For more information on owner distributions, see Chapter 4 – Owner's Distributions and Taxation, on page 30.

Bottom Line

Tax season, while challenging, presents opportunities for growth, learning, and strategizing. Whether you're an individual or a business owner, a proactive approach, coupled with the guidance of experts, can transform this daunting period into a phase of empowerment.

The world of tax and finance has a lot of twists and turns. Making informed decisions requires a deep understanding of these intricacies and how they impact your unique financial situation. Stay informed, consult professionals, and always ensure your decisions align with your financial realities.

3

Entity Choices: Taxation and Legal Protection

Initial Setup and Growth

Most small businesses start as a sole proprietorship or an LLC. Given the benefits, an LLC is often the better choice.

With an LLC, you're also afforded the option to choose how you'd like to be taxed: as a sole proprietor (pass-through taxation), a partnership, or even an S-corporation.

What is Pass-through Taxation?

When a pass-through business earns profits, it does not directly send a portion of the profits to the Internal Revenue Service (IRS). Instead, the profit is “passed through” the business and onto the tax returns of the business owners.

Tax Implications

Understanding how you'll be taxed is crucial. For example, S-corporations can save on self-employment taxes, but they require a bit more paperwork and come with salary requirements.

Review your tax structure regularly as your business grows. What makes sense for a small shop might not make sense for a larger operation.

Ensure that you keep personal and business finances separate. Regularly review the rules of maintaining an LLC in good standing to ensure that your liability protection isn't jeopardized.

Regularly renew any licenses or permits and ensure you adhere to any state-specific requirements.

Deciphering the Business Tax Tangle

All entrepreneurs aspire to profit. Yet, the tax implications of those profits can feel confusing. Let's simplify this:

When you make a profit, taxes consider it similar to drawing a salary. Hence, you encounter that added 15% payroll or self-employment tax. Ownership dynamics also play a crucial role. For a single owner, it's simple, but introduce multiple owners, and you're suddenly viewed as a 'partnership' in the tax realm. Just like sole proprietors, partnerships find their profits taxed, coupled with a self-employment tax.

How it translates: The percentage of the business you own determines your share of the profits and, consequently, the tax liability. So, while sole proprietors avoid additional tax filings, multi-owner LLCs must file a separate partnership return. This rule applies whether your LLC has two or twenty partners: more than one, and you're filing a partnership return.

A common question for new business owners is deciding whether to go for that S corporation tax status. My advice? Exercise caution in the first year. There's uncertainty whether it's beneficial, and you might inadvertently invite additional costs. More importantly, such an election isn't a one-time affair. You can look back three years and choose the S corporation tax treatment retroactively. So it's smart

to evaluate the business's financial roadmap before jumping in.

Why the hesitation around the S corporation? Firstly, the initial phase of business involves investments—be it equipment or infrastructure. While these expenditures might lead to profitable outcomes, they also entail depreciation, potentially offsetting your taxable income. Another noteworthy point is the approximate \$60,000 profit benchmark. When this is achieved by a sole proprietor, or doubled/tripled for partnerships with two or three owners, respectively, contemplating an S corporation becomes meaningful. However, bear in mind this estimation assumes equal ownership stakes, complicating the matter further.

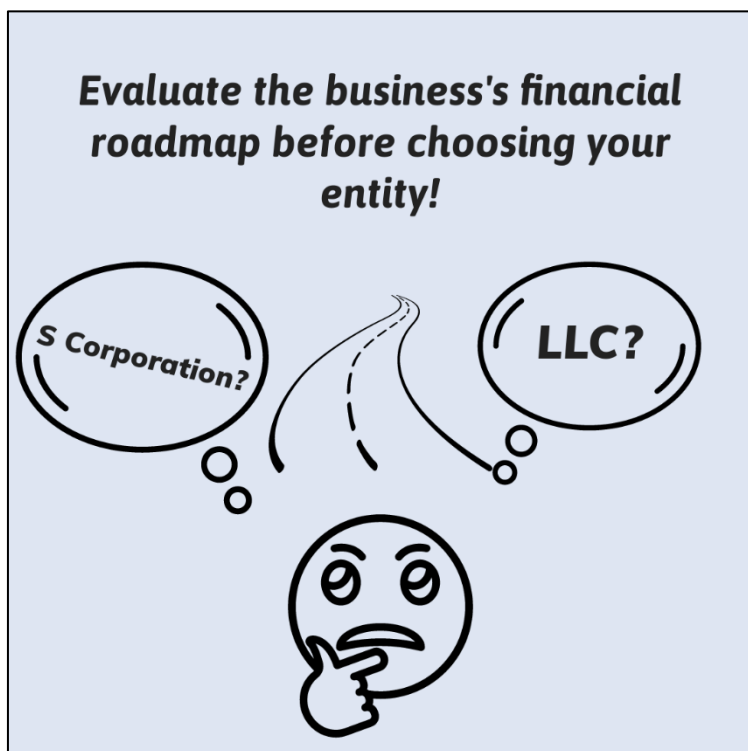
These little details really show why getting professional advice is a no-brainer. Connect with your accountant, dig into your specific situation, weigh the costs and benefits, and make sure you're in the most tax-efficient position. A few digital keystrokes and timely elections could lead to significant savings.

LLC vs S corporation

To clarify, once you convert to an S corporation tax-wise, your business identity remains an LLC. This doesn't demand any overhaul of your banking or operational systems. Only the IRS views you through a different lens, based on your tax election. A common misunderstanding I often encounter is the perceived

mutual exclusivity of an LLC and S corporation. In reality you're both—an LLC, but with an S corporation tax identity.

But remember, becoming an S corporation is a commitment. Once you switch, reverting isn't straightforward. If you opt-out of the S corporation tax status, a waiting period of five years is mandated before re-entry.



Entity Choices for Real Estate

Holding real estate in a separate LLC can protect the property from liabilities of the primary business and vice versa.

Separate LLC ownership for operating entities and real estate assets is smart. This segregation primarily offers legal protection, shielding you from potential liabilities of the other. What if someone got hurt at your shop or slipped in your parking lot? The distinct LLCs ensure the liabilities of one don't jeopardize the other.

This separate enterprise should not only be self-sustaining but also profitable. All expenses, from repairs to administrative costs, must be settled in a manner that solidifies its independence. For instance, if a loaner car needs repairs at your shop, the costs should be paid at full retail. Discounting services due to ownership ties makes your business vulnerable in court. Lawyers may argue against the independence of the entities, rendering the LLC's purpose moot.

However, for tax purposes, keeping the real estate ownership within a single-member LLC simplifies matters. It still provides legal safeguards while allowing for sole proprietor tax treatment. Hence, your rental income and expenses are merely additional sections in your personal tax return, saving on additional filings and costs.

Entity Choices for Loaner Car Company:

- ➔ **Protection** - If you have a fleet of loaner cars, there's potential risk involved. Separate LLCs can limit the liability if something goes wrong with one of the cars.
- ➔ **Tax Implications** - Different states have various tax implications for vehicle-related businesses. Know the specifics for your state.
- ➔ **Operational Considerations** - Ensure compliance with insurance regulations and any state-specific requirements for a fleet of loaner cars.

No matter the business venture, it's crucial to do thorough research and possibly consult with a legal or tax professional to ensure you're making the right entity choice. Taking the time to get it right at the outset can save headaches and potential financial loss in the future.

Ensuring Legal Protection for Your Business Assets

In the area of business, it's essential to ensure that our assets are protected from potential lawsuits. Many individuals believe that they're safe from litigations against their rental real estate company or their shops due to certain legal protections. While there's a degree

of truth in this, understanding the depth and breadth of this protection is necessary.

Setting up separate LLCs for different parts of your business provides insulation, ensuring that your business ventures do not get entangled with one another. However, merely having an LLC is not sufficient. For an LLC to stand up to scrutiny, it must operate as a distinct and autonomous entity.

Many overlook the hidden expenses linked with maintaining this separation. Some states impose sales tax on short-term car rentals or loaner cars. These unforeseen costs can accumulate rapidly. Is this approach valuable? Absolutely, as it offers legal protection. However, the associated expenses shouldn't be underestimated. View it as investing in an insurance policy; its value and cost might fluctuate based on the business's scale.

When contemplating the structuring of LLCs, I always advise clients to weigh the pros and cons. For those with sizable assets or substantial liabilities, the cost of setting up and maintaining separate entities might be justified. Conversely, for smaller ventures, it might be more cost-effective to enhance insurance coverage.

A significant caveat about loaner car businesses pertains to insurance. Several insurance providers have stipulations regarding the usage of vehicles. It's vital to communicate with insurance agents transparently, ensuring your practices align with the

coverage policies. An oversight can result in unforeseen liabilities, leaving businesses exposed.

In the end, safeguarding your assets requires proactive involvement. Regular consultations with professionals, be it accountants or insurance agents, is a must. This ensures optimal decision-making for your business, reducing the potential for undesirable surprises.

Establishing your business as an LLC with a sole proprietor tax identity is a sensible starting point. As profits rise, and if they breach the \$60,000 threshold, considering the S corporation status becomes necessary. Yet, the heart of the matter remains the same: structured and informed decision-making ensures you part with only the tax you truly owe.

4

Owner's Distributions and Taxation

When shop owners think about taking out money from their business in the form of distributions, a common question that comes up is, "Will I be taxed on this money?" The short answer? No. However, as with most things in business finance, the complete picture is more intricate.

One principle to always remember is that as an S corporation, it's crucial to pay yourself a "fair and reasonable wage." Profits above this wage can be taken out as distributions. While these guidelines are

mostly relevant to S corporations, they also largely apply to partnerships, though with some smaller details we won't get into here.

Reflecting on past discussions...

Like **episode 17** of Business by the Numbers, where I addressed the notion of fair wages versus draws. Although the primary focus wasn't taxation, it did lay a foundational understanding of how to set up and manage your withdrawals if you're an S corporation or even an LLC that could transition to an S corp in the future.

"BUSINESS BY THE NUMBERS: S-CORP OWNERS DISTRIBUTIONS AND PAY"

Given the gravity of these decisions, always seek guidance from a seasoned accountant or CPA before making moves that you're uncertain about. For instance, a client recently inquired about raising his draws due to the booming state of his business. His

question led to a conversation about the balance between payroll and distributions.

In essence, it's not the act of taking out distributions that's taxable, but rather the profits generated by the business. And it's the profit on which you're taxed, regardless of what you do with the cash afterward, be it distributions, reinvestments, or other expenses.

Distributions Defined

Distributions, aptly named as distributions of profit, are essentially what's left after your business's obligations. If there's no profit, there can be no distributions. And it's important to note, payroll taxes only apply to salaries, not distributions.

In an illustrative example: Let's say you own a lemonade stand turned S corporation. If it generates a profit of \$100,000, you'll be taxed on that amount. This remains true whether you distribute that profit or leave it within the business.

When it comes to navigating the complexities of business finance and distributions, remember that profit is the determining factor for taxes, not necessarily your decisions on distributions. Always engage with professionals to ensure you're making informed decisions and managing your financial responsibilities with expertise.

Many business owners find themselves navigating the complex world of S corporations and questioning the taxation rules surrounding them. A common question I hear is, "Why am I paying tax when I haven't taken any money out?" It's a legitimate concern, but it fundamentally misunderstands the core principle of taxation. The IRS is interested in your income, not what you choose to do with the cash.

When you're an S corporation and you turn a profit without distributing any of it, you're bound to question the fairness of the tax system. The core lesson here is this: even if you don't distribute any money, you must at least distribute enough to cover the tax bill. Keeping \$100,000 in your account while fretting about a personal tax liability of \$20,000 is counterproductive. Why? Because you're essentially yelling about money that's right there in your business. And to the misconception that you'd be taxed again upon withdrawing it – that's unfounded. Once you've settled your tax bill for the past year by April 15th, any leftover money is yours to distribute without any tax consequences. In simple terms, your taxable amount remains the same, regardless of whether you've distributed \$50,000 or \$100,000.

What is the order of concern for the IRS regarding taxes?



Taxable Distributions

One of the S corporation's standout features is the fluidity it offers with money. Whether you're looking to invest back into the business or distribute funds, the flexibility is incomparable. If you're looking to loan your business money, there are certain considerations to be had. The IRS expects interest on these loans. While this might seem daunting, in practice, the

relationship between business deduction and personal income results in a balanced equation.

Additionally, the transfer of funds between different businesses can be a gray area. Intercompany loans, a common practice, essentially involve transferring money between business entities. For instance, if you were to buy a property for your business through a separate LLC, you could transfer funds from your primary business to this new entity. The intricacies and legal frameworks of these transactions vary but are built on foundational principles of taxation and finance.

The overarching lesson for S corporations is the separation between distributions and taxable amounts. The notion of "distributions in excess of basis" might seem intimidating, but it boils down to the discrepancy between what your business made in profit and what you took as distribution. The example of buying a truck illustrates this challenge appropriately. If you purchase a vehicle using a loan and end up with zero profit due to depreciation but still have money in your account and decide to distribute it, you've ventured into the realm of taxable distributions.

Imagine this: Your shop hasn't made any profit, yet you've already taken out \$40,000. This presents a quintessential example of a distribution in excess of basis. In simpler terms, it's like withdrawing more money than what's available in your account. The IRS

is not fond of this scenario. If they probe into your finances and see this inconsistency, they'll highlight it as a taxable event. It's an S corporation's worst nightmare. Suddenly, the IRS treats you like a C corp, insisting you owe capital gains on that \$40,000 distribution, similar to a dividend.

Before you protest, here's a deeper understanding: If you ever find 'loan to shareholder' appearing in your balance sheet, it typically refers to these excess distributions. Instead of categorizing this excess as a distribution, it's positioned as a loan from the company to you, the shareholder.

Loans to shareholders aren't illegal or frowned upon, but they do come with strings attached. First, the loan needs to be repaid, and not just randomly. There should be a consistent method of repayment over time. However, repayment isn't the only solution. If the next year turns out profitable, these loans can be reclassified as distributions and offset against the profits.

The IRS has grown more vigilant, especially for sizable amounts under 'loan to shareholder'. While smaller amounts might slip under their radar, more significant amounts attract attention. For instance, a \$1.4 million loan to a shareholder is bound to raise eyebrows, especially if the shareholder continually drains the company's resources.

The EIDL Influence

Another financial element that has muddied the waters in recent times is the EIDL (Economic Injury Disaster Loan). Unlike traditional loans, the EIDL comes without any specific purpose assigned to the disbursed amount. While there are guidelines, it's not always black and white about how these funds should be used.

Remember: Taking a loan isn't the same as generating profit. It might be tempting to view a hefty EIDL amount combined with your profit as a big pool of available cash, but it's a risky path. The IRS takes a dim view of individuals confusing EIDL loan amounts with distributable profits. If you've taken more than what you've earned in profit, you're venturing into unsafe territory.

A balance sheet typically comprises three sections:

1. *Assets*
2. *Liabilities*
3. *Equity*

If your equity section displays zero or even negative, it's an alarm bell, signaling that you're not in a position to take out distributions. A positive equity reflects genuine profit, which you can then distribute.

While it might seem enticing to dip into your company's funds now and then, tread cautiously. Distinguish between actual profits and loans. Remember, while the EIDL provides a longer repayment period, the IRS might not be so patient. Always ensure your distributions align with your profits to avoid any unwelcome surprises.

Bottom Line

Profits are the lifeblood that ensures a business thrives. They serve as the cushion against the inevitable storms that businesses weather, particularly with debts such as the EIDL – a working capital loan of a scope and duration we've never before witnessed. It's critical to distinguish between the guidelines set by the SBA and the rules regarding distributions, a nuance often overlooked. Distributions, in nearly all circumstances, aren't taxable - taxes are on profits, *not* distributions. This will serve as your compass, ensuring you make informed financial decisions and stay in the IRS's good books.

5

Can I Expense That? Should I?

Let's say I have a client and they want to buy a four-wheeler and an 80-inch flat-screen TV. Why? What's the purpose behind these purchases in relation to their business?

If they're a landscaping company, they might say, "I want to buy the four-wheeler because I have several large properties, and it's very time-consuming to walk them. Having a four-wheeler would expedite the process of checking out the entire landscape and making our work more efficient."

On the 80-inch flat screen, they might say, "Well, I have a front office where potential clients come in. I want to showcase our previous landscaping projects on a big screen. The TV will be in the waiting area, running a slideshow of our completed projects."

Given these explanations, we can now approach the expenses from the perspective of "ordinary and necessary."

Four-wheeler:

Ordinary: Do other landscaping companies use equipment like four-wheelers for large properties? Possibly.

Necessary: Is it helpful and appropriate for the business? Yes, because it makes the assessment of large areas more efficient.

80-inch TV:

Ordinary: Do businesses use TVs to showcase their work to potential clients? Absolutely.

Necessary: Is it helpful and appropriate? Yes, because it's a marketing tool, enhancing the client experience and showcasing the quality of work.

Therefore, based on the criteria of "ordinary and necessary," both of these expenses could potentially be

justified as business expenses. But, it all hinges on the intent behind the purchase and its application to the business. It's not about the item itself; it's about the role it plays in your operations.

But remember, even with the best justifications, documentation is crucial. Always keep records and be prepared to show how these expenses genuinely benefit your business.

Business Expenses: Where to Draw the Line

Navigating the complexities of business expenses can be daunting. Let's consider a scenario that many professionals might find familiar:

When my client approached me about purchasing a four-wheeler for her business, my initial question was straightforward: "What's its intended use?" Her reply painted a vivid picture. "It's for leisure rides around the field, doing wheelies down the street, and maybe letting the kids have some fun on the farm."

Understandably, I had to point out that such use wouldn't qualify as a business expense. The principle is simple: For an expense to be written off, it has to be **both** ordinary *and* necessary for the business.

However, when she later described a more pragmatic use for the same four-wheeler – to transport malfunctioning vehicles around the shop, push dead vehicles, and even to plow snow in the winter – the

narrative changed. The same item, but now with a legitimate business purpose.

This principle extends to other examples, like a TV. If it's being used by the poolside for personal relaxation, it doesn't qualify. Yet, if that same TV is mounted in the shop displaying work schedules, appointments, and used for staff training, it becomes a valid business expense.

The challenge often isn't about whether an expense is valid or not, but rather its context. While the IRS may evaluate these expenses, it's crucial that the reason for these purchases remains consistent and justifiable for business purposes. Moreover, any attempt to cut corners with expenses can attract unnecessary attention and potential penalties.

A common sentiment in the business world is "Just write that off!" The allure lies in the tax benefits that come with business expenses. Depending on one's income bracket, anywhere from 15% to 50% of that expense could be written off. A rough estimate for many would be around 25%. This means an item like a TV costing \$1,000, would effectively cost around \$750 when factored in as a business expense.

Vehicle purchases can be a gray area. Whether it's loaner cars, shop trucks, or personal vehicles used for business purposes, the lines can blur. The key lies in the vehicle's primary purpose and the consistency of its usage. For instance, a fleet of loaner cars

exclusively used by customers is a clear business expense. A personal truck used occasionally for business purposes? Not so clear-cut. Additionally, the IRS prefers the vehicle to be registered under the business name to validate the expense.

While navigating these gray areas can be challenging, the guiding principle remains: Any expense should be ordinary and necessary for the business. The task lies in making well-informed decisions and always ensuring that any expenditure can be justified in a business context.

Understanding Business Expenditures and Tax Implications

The significance of expenditures in businesses can't be understated. The extent of these expenses can often invite scrutiny, particularly when it comes to meals. Their evaluation largely depends on the proportion they hold concerning the company's sales. For instance, a \$10,000 meal expense might seem excessive for a business with a turnover of \$100,000. In contrast, it's barely noticeable for a company with a turnover of \$100 million.

It's crucial to comprehend the relative size of such expenses, understanding the percentage they occupy in relation to the overall sales. A higher percentage can sometimes spell trouble. Meals are a primary example of this, given we eat regardless of our

professional commitments. The IRS, while emphasizing expenses being ordinary and necessary, is particularly attentive to expenses that offer personal benefits. Examples include luxury items like race cars, boats, and wine, which the IRS often frowns upon.

Travel or vacation costs are often highlighted when it comes to personal benefits. Distinguishing a business trip from a vacation can be tricky, but the IRS has set guidelines. For a journey to qualify as a business trip, the primary purpose must be business oriented. If a seven-day trip includes four business days and three personal days, it can still qualify as a business trip.

The trip must be ordinary and necessary concerning the industry. The purpose and potential benefits of the trip to the business are essential.

Planning is crucial. While planning doesn't necessarily mean mapping out details months ahead, a clear business purpose and strategy must be apparent.

For instance, a trip from Seattle to Southern California primarily for leisure is not deductible. However, if the purpose involves engaging with fellow business owners, examining their operations, and learning from them, it could qualify for deductions. There's an added nuance for international travel; only 25% of the trip needs to be business oriented.

It's evident why many coaching companies select destinations for conferences – it allows attendees to

mix business with pleasure while also benefiting from deductions.

Lastly, let's address a category of expenses that often becomes a gray area: supplies. This includes shop supplies, office equipment, and office expenses. Due to their nature, these often become repositories for miscellaneous, sometimes personal, expenditures. Regular vendors like Walmart, Amazon, and Home Depot can pose challenges, as the line between personal and business purchases might blur.

When the IRS examines these expenses, the price point and vendor name are key areas of interest. Although minor expenses might not catch their attention, substantial amounts will. To stay ahead, businesses must maintain a well-documented trail of these expenses, explaining their business purposes. For instance, a company spending \$50,000 on office supplies with a \$500,000 turnover might be viewed skeptically.

The Double-Edged Sword of Business Expenses

In managing your business, moderation is the key. It's tempting to funnel personal expenses through your business, especially when you see the array of potential deductions. We've dedicated considerable time discussing the advantages and legitimate claims. However, it's imperative to understand that while it might be legally allowed, it isn't always advisable.

The Ever-Present Audit Risk

The appeal of claiming ambiguous expenses can increase your chances of a tax audit. Not every IRS agent is out to get you, but neither are they all easily duped. I've witnessed instances where diligent clients, with meticulously maintained records, faced intense scrutiny. It's crucial to remember that contending with the government means challenging an entity that acts as the investigator, judge, and jury. The costs of fighting an audit can outweigh the benefits of contested deductions.

The Real Picture of Your Financials

Blurring personal and business expenses can distort your company's genuine financial health. A frequent issue I've seen is business owners questioning their margins based on misleading data, only to find that personal purchases were clouding the picture. This not only misleads you as the owner but can also result in misdirected frustrations at staff or management.

The Lender's Perspective

Banks have stringent guidelines when assessing loans. If your reported profits are minimal due to excessive deductions, your chances of securing significant financing diminish considerably. Remember, the IRS might not be your only audience; financial institutions

rely heavily on your tax returns to assess creditworthiness.

Selling Your Business

Your endgame might involve selling your business. Potential buyers evaluate businesses based on profitability metrics. **If your records show minimal profits due to inflated deductions, you're undermining your business's perceived value.**

Trust is a significant factor in business transactions. A seller who admits to under-reporting to the government may not inspire confidence in potential buyers.

Moreover, even if you persuade a buyer of the business's real value, their lenders might not share that vision. A mismatch between reported profit and the asking price can jeopardize financing, derailing the sale.

Bottom Line

Being self-employed offers numerous tax benefits, but it's essential to exercise discretion. Overindulgence in deductions can obscure your company's actual costs and performance, potentially reducing its valuation or complicating a future sale. The adage "Pigs get fat, hogs get slaughtered" rings particularly true here. It's a balance of leveraging perks without inviting undue scrutiny or unintentionally diminishing your

enterprise's value. Always proceed with informed caution.

Understanding the nature and proportion of business expenses is paramount. It not only aids in maintaining financial transparency but also ensures a smooth run-in with tax authorities. Always remember, expenses should be both ordinary and necessary for the business's nature.

6

Not All Deductions Are Equal

In the world of taxes, the overwhelming majority of your business expenses, from cost of goods sold to operational costs, are largely treated the same way when it comes to income tax. But, of course, there are a few sneaky exceptions to this general rule—particularly when tax season is upon us. In this chapter, we'll break down these tricky bits, why they matter to your wallet, and how you can handle these special categories of expenses.

Expense Classification: More Than Semantics

"Is this an advertising cost, a discount, or a warranty expense?" These are the kinds of questions that I often get from shop owners. Even though these questions might appear trivial, they're pretty important both for the analysis of your financial statements and for tax purposes. We spend a significant amount of time with our clients to explore the most advantageous methods of categorizing these expenses.

To be clear, most expenses, regardless of their classification, will end up being deducted from your taxable income. However, the devil is in the details—or, in this case, that rare 1% of exceptions which we will delve into throughout this chapter.

The Curveballs of the Tax Code

Think the U.S. tax code is a static, straightforward document? Think again. The tax code has many quirks and subtleties, many of which the average shop owner is not aware of. For example, the previously combined category of "meals and entertainment" in your expense accounts, is now just "meals". Until a tax reform in 2018, this category was a single line item in many accounting software solutions, including versions of QuickBooks. However, post-reform, entertainment expenses have become non-deductible. That's right; your business outings to football games or concerts can no longer serve as tax deductions. The

IRS perceives this category as ripe for abuse, particularly by larger corporations.

Now, you might say, "Why should I care about what large corporations are doing?" Well, when they enjoy tax benefits for excessive entertainment expenses, it impacts the general taxation ecosystem, essentially redistributing the tax burden. So, the first action item? Rename your expense categories to strictly say "meals," eliminating the outdated "entertainment" label.

Interestingly, the removal of the entertainment deduction has paved the way for inventive accounting practices. Some businesses have started to reclassify what used to be entertainment expenses as advertising costs. While we don't endorse this practice, it underscores how tax changes can lead to a perpetual cat-and-mouse game between the IRS and taxpayers.

Meals: The 50% Versus 100% Deduction

The world of meal deductions is not as straightforward as you might expect. The IRS classifies meal costs into two broad categories: 50% deductible and 100% deductible. The 50% category largely encompasses meals that occur in the course of daily business activities. This category is designed to acknowledge that while meals are often mingled with

business activities, they are also a necessity of life and would occur regardless of your job.

On the other hand, 100% deductible meals are those provided for the convenience of the employer or employees, often within the workplace itself. For example, snacks and beverages in your business's waiting area can usually be fully deducted.

The primary reason for providing meals for an in-house meeting is two-fold: to streamline convenience for both employer and employee. Say you're hosting an internal meeting. Providing on-site meals ensures that attendees don't have to fend for themselves, thereby optimizing time and maintaining the flow of the meeting.

However, the IRS of course has some rules about these food perks. If you're regularly doing something like "Taco Truck Friday" it will not be considered fully deductible. In contrast, sporadic and unplanned meals, say, one Friday feast followed by a long interval, may qualify for a full deduction.

The key takeaway? Regularity and predictability are red flags for the IRS when it comes to deductions. Hence, designating these meals under generic titles like 'employee promotions' or 'meeting expenses'—avoiding the mention of 'meals'—will keep you in a safer bracket for deductions.

Client entertainment is another often misunderstood territory. Events like customer open houses or youth

educational events, while hosting meals, are primarily for the clientele, not the hosting business. It's imperative to classify them appropriately. For instance, an 'open house' could better fit under 'advertising expenses', reflecting its core purpose: brand promotion.

Interestingly, while most fall under the 50% or 100% categories, there's a third, albeit rare, category: the 80% meals. Mostly for people bound by DOT hours like pilots or truckers, these meals are partially deductible for the self-employed. Not something you see a lot in standard tax returns, but it's a cool little nugget for those into tax trivia.

The Limits of Charitable Deductions

The nuances continue with charitable contributions. On the surface, they might seem straightforward: you donate, you deduct. But, the actual process is more complex. Say a business grosses \$105,000 and donates \$5,000 to a church. The profit isn't neatly reduced to \$100,000. The full \$105,000 is considered business income. The charitable contribution, meanwhile, gets deducted on personal taxes, leading to potential complications for those who don't itemize their deductions.

Here's another twist. Sponsorships, like backing a local T-ball team or buying a spot in a charity golf event, often get miscategorized as charity. While these

may support charitable organizations, they primarily serve as advertising ventures for businesses. It's advisable to categorize them as such.

Donations aren't just monetary. What happens when businesses donate equipment? Well, if you've already claimed a deduction when you bought a piece of equipment, donating it won't get you another deduction, even if its value is significant at the time of donation.

To round off, let's look at waived service fees. Imagine a \$2,000 service ticket you decide to waive for a charitable organization. If you decide to run this through your system, while the parts might be deductible, the waived labor might not be.

In the labyrinth of deductions, understanding these little details is very important. When it comes to the work you've done for charitable causes, the guidelines for what can be deducted are quite specific. If your team performed a repair job for a charity, you can only write off the direct expenses incurred—meaning the cost of parts and the wages you paid your employees. It's a common misconception to assume you can deduct the \$2,000 you didn't charge the charity; unfortunately, you can't. This is because opportunity costs—the money you could have earned otherwise—do not qualify for a tax deduction.

Interestingly, some businesses prefer to document charitable work at its full retail value. They report a

\$2,000 sale and a \$2,000 charitable expense, effectively balancing each other out. This doesn't alter the tax implications, but it does give a fuller picture of the opportunity cost involved.

However, use caution when categorizing expenses as charitable contributions. For instance, if you perform a free repair job for a needy individual, don't classify it as a charitable act. To qualify for a charitable tax deduction, the beneficiary must be a recognized charity. In such scenarios, it might be more appropriate to label the expense as bad debt, which is 100% deductible.

It's worth noting that the majority of our clients operate S-corporations, partnerships, or sole proprietorships. The rules for charitable deductions generally apply to these business structures. C-corporations, however, face different guidelines even though the fundamental concept remains the same.

The Landscape of Deductible Insurance

Moving on to insurance, most premiums are fully deductible. This covers a wide spectrum of insurance types including health insurance for your employees, liability insurance, and workers' compensation. However, there are exceptions: notably disability and life insurance premiums generally aren't deductible.

The Importance of Disability Insurance

The topic of disability insurance often goes unnoticed, mainly because employees usually cover the cost. However, considering the nature of work in industries like automotive repair, having a disability policy is crucial. If an employee were to sustain an injury outside the workplace—say, breaking a femur while dirt biking over the weekend—the disability insurance kicks in. This is particularly important for roles that require physical labor, as an injured worker won't be productive for an extended period.

In such cases, having disability insurance can prove to be invaluable, and it's an option worth exploring if you haven't already done so. It's not uncommon for employees to face periods of disability, rendering them unable to work for weeks or even months. In these challenging moments, the absence of a regular paycheck hits hard. This is where disability insurance steps in, providing not just a safety net for the employee but also alleviating potential pressures on the employer. While these policies don't replace the entire wage, usually covering around 80% of the standard earnings, they play an invaluable role during the recuperation period.

Many employers hold a deep sense of loyalty to their long-serving employees. Imagine one of your long-time employees suddenly incapacitated for three months. It's heartwarming to witness employers ensuring such employees still receive pay during their

recovery. However, the financial implications of this noble act can be huge.

This brings us to the affordability of disability insurance policies like Aflac. For a relatively low monthly premium – often as minimal as \$6 to \$20 – employers or employees can secure a potential financial lifesaver. While everyone hopes never to cash in on such policies, it's always better to have a safety net in place.

Deducting disability insurance as a business expense is where things get intricate. Technically, you can. If an employer foots the bill for the disability insurance of their employees, that amount can be written off. However, this isn't a universally exercised practice. Here's the catch: If you opt for the deduction and an employee subsequently claims disability benefits, those benefits become taxable. Given the low premiums versus potential high payouts, the tax implications usually outweigh the deduction benefits.

Life insurance operates under similar principles. Though it can be deducted in some cases, the vast potential of the ultimate payout versus the comparatively minor tax savings from the premiums means that most practical advisors steer clear from recommending these deductions.

Accountants are constantly alert, ensuring that all classifications and deductions are compliant and beneficial. This vigilance extends to items like life and

disability insurance premiums to guarantee they're appropriately categorized. The intricate ties between deductions and subsequent taxation can often be overlooked by those unfamiliar with the tax law.

Lastly, it's crucial to understand the area of fines and penalties. By and large, these are non-deductible. Simply put, the IRS is unwilling to offer tax breaks for transgressions, whether they're minor infractions like parking fines or more significant ones like late tax filings. Only genuine penalties should fall into this category. Always scrutinize and categorize correctly to avoid losing out on potential legitimate deductions.

Bottom Line

Tax season isn't just about going through the motions. By understanding how various expenses are treated, you can make more informed decisions that could save you money and provide a clearer picture of your business's financial health.

7

Handling Big Purchases

Recently, I had an enlightening conversation with a client who was contemplating purchasing a new equipment trailer for her shop. Her question revolved around the best way to proceed: should she buy it, lease it, or pay in cash? More importantly, how would each option impact her tax liability?

While I did provide her with the answers (which we'll delve into shortly), this interaction sparked a realization. Such questions are likely on the minds of many shop owners. Consequently, in this chapter we'll

dive into the nuts and bolts of financing your equipment, why keeping cash on hand is key, and how all this plays out when tax time rolls around.

The term "buying equipment" can be deceptively vast. Does it mean outright purchase, leasing, or using cash? And what about the more substantial investments, like revamping your facility with a new roof or signage?

There are three main categories of large purchases that we see in shops:

1. **Equipment:** This category covers a broad spectrum, both in terms of utility and cost. From the tax perspective, if a tool or piece of equipment is valued at \$2,500 or less, it's generally expensed in the first year. Anything above this amount is depreciated. However, with provisions like accelerated depreciation, even larger purchases can sometimes be fully written off in the initial year.
2. **Vehicles:** Different financing methods are available depending on the type and utility of the vehicle in question.
3. **Real Estate and Improvements:** From property acquisition to major renovations, real estate decisions can have substantial tax implications.

Diving deeper into equipment financing, consider the case of an alignment rack, which can sometimes soar to a staggering \$130,000 in cost. How should one approach such a purchase? While there's no universal solution, my methodology typically involves a thorough examination of the financials.

For businesses flush with cash, an outright purchase might make sense, especially in the face of rising interest rates. Conversely, if paying out such an amount would significantly dent your reserves, financing becomes a more agreeable option.

In the realm of financing, we encounter two predominant choices: 'Lease to Own' and traditional bank loans. While the former binds you to the interest for the entirety of the term, bank loans offer more flexibility, often at more favorable rates.

In an ideal scenario, I advocate for a proactive approach. If you anticipate a significant purchase, it's wise to talk with your bank. Whether it's securing a loan or establishing a line of credit, having these provisions in place allows for informed, quick decision-making when the time comes.

Taxation-wise, whether you opt for cash, a bank loan, or a lease, the immediate tax implications remain consistent. Paying in cash provides immediate tax relief equivalent to the purchase amount. On the other hand, financed purchases, whether through banks or

leases, offer tax benefits spread over the term of the loan or lease.

In essence, the route you choose will depend on your current financial standing, long-term goals, and risk appetite.

Leasing Large Equipment

In many businesses, particularly dealerships, there's often a need for large copy machines. Given their considerable cost, most prefer leasing. The rationale? As equipment ages, its efficiency may decrease. Instead of investing heavily upfront, businesses pay a monthly fee, typically around \$400. After three years, they return the equipment and often opt for a fresh lease on the latest model.

Vehicle Leasing Insights

When we talk about leasing, vehicles immediately come to mind. Let's dissect this option.

A vehicle lease operates on a straightforward principle. Make monthly payments for the agreed term, and at the end, you can either return the vehicle or buy it, depending on its residual value.

However, from a tax perspective, it's important to note that leased vehicles aren't wholly deductible. Only the monthly lease payment is considered an expense. Say, for instance, you decide to lease a Ford F-150 with

monthly payments of \$800. Only this monthly payment is deductible, regardless of the truck's actual price.

One common question is the eternal debate: to lease or to buy? In the current market, marked by unprecedented new and used car prices, a lease makes sense for those who like renewing their ride frequently. Leasing allows for a fresh vehicle every few years without the hassle of warranties expiring. On the flip side, buying gives you ownership of the asset, but there's the whole guessing game of what it will be worth 3 years down the line.

Interestingly, many shop owners prefer buying due to the nature of their work. They aren't wary of vehicles out of warranty as they handle repairs themselves. Luxury cars, which tend to depreciate rapidly, are more commonly leased.

If your primary objective is saving on taxes, leasing may not be the best approach. When leasing late in the year, like October, your first payment might be delayed till January, offering no tax deduction for the year.

Buying vs. Financing a Vehicle

When it comes to outright buying or financing, the tax treatment is identical. You can write off the entire amount in the first year based on the vehicle type. While dealerships nowadays push for financing due to

better profit margins, cash payments can be beneficial if you wish to avoid interest rates.

However, in an era of high inflation, financing seems the smarter choice. With car manufacturers offering low interest rates, often subsidized, it aligns well with or even below current inflation rates. If you're cash-rich, of course, paying upfront can be considered.

PRO-TIP:

If pressured into financing when you're more inclined to pay cash, take the financing and then pay it off in a month. Most car loans lack prepayment penalties.

Tax Treatments Based on Vehicle Types

Trucks: Trucks are straightforward. A full-size truck qualifies for accelerated depreciation. Thus, you can write off the whole cost in the first year. Trucks are beneficial for both shop utility and tax write-offs.

SUVs: SUVs have two categories for tax purposes: large and small. The IRS defines large SUVs as those

with a gross vehicle weight rating above 6,000 pounds. Large SUVs can be fully written off in the first year, while small SUVs, like cars, have limitations. Cars and small SUVs limit the first-year write-off to \$18,000, with the rest depreciated over five years.

Real Estate Tax Implications

Real estate is another avenue where business owners seek tax benefits. When considering commercial real estate, the tax advantage isn't instant. The property is depreciated over 39 years, with the land's value non-depreciable.

Expanding an existing building's footprint also falls under this prolonged depreciation timeline. However, there is a silver lining: Qualified Leasehold Improvements (QLI). Defined as improvements not expanding a building's footprint, QLIs made after 2018 offer significant tax benefits.

Understanding these varied tax implications can help you make better financial decisions resulting in business growth and more cash in your pocket.

Understanding Qualified Leasehold Improvements

When you think about beautifying your shop space, certain tasks may come to mind: painting the floors, revamping a waiting area, or refurbishing your break room. It's essential to understand that while these

improvements can add value and aesthetic appeal to your shop, most of them—almost 99% in fact—do not actually increase its square footage. These are what we typically classify as 'qualified leasehold improvements'. However, before you act on the assumption that these improvements can lead to significant tax savings, there's a crucial step you shouldn't skip: consulting your accountant.

The Importance of Preemptive Financial Counseling

One of the challenging aspects of being an accountant is having end-of-year discussions where clients reveal major financial moves they've made, assuming they've secured tax advantages. For instance, consider a client who undertook a \$200,000 addition, paid in cash, thinking it would favorably affect their taxes. The grim reality can be that, despite this huge expenditure, they still face a hefty tax bill. Such scenarios underscore the significance of seeking professional advice before making substantial investments.

"Remember, your accountant isn't just there for year-end tax calculations; they're there to guide you throughout your financial journey. "



Decisions Beyond the Immediate Financial Impact

It's not about discouraging investments; sometimes, the decisions we make, like the aforementioned \$200,000 expansion, can be immensely beneficial for business growth. The issue is not with the investment itself but rather with the approach. An informed decision, like choosing to finance the expansion instead of paying in cash, can make a significant difference in maintaining a business's financial health.

Improvements and Their Tax Implications

Broadly, there are two categories of improvements:

Minor Improvements: These are tasks like painting, siding, roofing, or even repaving the parking lot. They provide accelerated depreciation advantages.

Major Expansions: Expanding the total square footage of your shop or adding new sections will indeed offer tax write-offs. However, they usually need to be written off over a much lengthier period, such as 39 years, which might not be beneficial for short-term tax planning.

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Harnessing the Power of the 1031 Exchange

It may sound too good to be true, but there exists a method in real estate where you can sell a property, even with substantial gains, without incurring tax liability.

The Concept of a 1031 Exchange

A 1031 exchange provides real estate investors an avenue to defer taxes on certain property sales. However, it's not a straightforward process. To really

get the most out of it, you need to know the ins and outs.

A Classic Scenario: The Tax Pitfall

Imagine you acquired a building in 2000 for \$500,000. Fast forward to today, and you've received an enticing offer of \$1.5 million. While this sounds lucrative, diving into the numbers paints a different picture.

When you factor in the property's depreciation (usually spread across 39 years for real estate), your initial purchase price reduces. Let's say you've accounted for \$200,000 of depreciation. This leaves you with a base of \$300,000 against the sale.

Now, subtract your base from the selling price, and you have a taxable gain of \$1.2 million. Depending on various factors, the tax rate can hover around 25%, resulting in a hefty \$300,000 tax bill. After paying off your obligations and potential mortgages, the final profit might be significantly less than anticipated.

Addressing Misconceptions

A common mistake property sellers make is overlooking depreciation. Though you might have bought and sold the property for the same price, depreciation deductions taken over the years can cause a taxable event. Essentially, you can't enjoy tax

deductions without their subsequent consequences when selling.

The Magic of the 1031 Exchange

The 1031 exchange serves as a lifeline to investors aiming to re-invest their proceeds into a new property. Instead of immediately paying taxes on the sale, you can roll over the proceeds to a new property, essentially deferring the tax.

Picture trading in a car with negative equity. The deficit doesn't vanish but is carried forward to your next purchase. The 1031 exchange mirrors this but with the promise of potential zero tax implications if managed wisely.

Implementing the 1031 Exchange

Executing a 1031 exchange requires the involvement of a qualified intermediary, an indispensable step. This entity, which could be a company, an individual, or a law firm, acts as a temporary custodian of the sales proceeds, ensuring you don't directly handle the money. Their role is crucial in maintaining the integrity and validity of the exchange process.

Real estate, as with other sectors, is dynamic. From autonomous cars to digital transactions, the future remains unpredictable. Being equipped with tools like the 1031 exchange can provide the agility and

flexibility necessary for success. As with any intricate financial strategy, seeking expert advice is very important. Embracing the 1031 exchange can be a game-changer, but only if executed correctly.

The Intricacies of the 1031 Exchange

The beauty of the 1031 exchange lies in its flexibility. For instance, it allows a smooth transition between commercial, industrial, and residential rental properties. The main guideline? The property must produce income. Thus, as long as you're transitioning from an income-generating property to another, the transition is allowed.

But what if you don't want to use the new property as a business? Perhaps you are transitioning from a commercial establishment to a beach house? A direct switch would violate the 1031's criteria. However, if the beach house is rented out and serves as an income-generating asset, it qualifies. The crux lies in the intent. If you purchased the property intending it to be an income-generating asset, even if that changes later, the 1031 exchange remains valid. (Be careful though. To safeguard against potential IRS inquiries, it's smart to genuinely rent out the property, at least initially. Having that tangible proof can be a lifesaver.)

Moreover, the exchange doesn't need to be a one-to-one ratio. Consider selling a property worth \$1.5 million. Instead of purchasing one equivalent

property, you could invest in three properties each worth \$500,000. The essence is to view the transaction as a collective deal. This interchangeability means that you could also consolidate, trading in three \$500,000 properties for one that costs \$1.5 million.

In essence, the 1031 exchange provides fluidity, whether you're transforming one property into two, two into one, or even five into one. However, the process is time-bound, requiring completion within 180 days. This six-month period, while seeming more than enough, can be tricky, especially if unforeseen complications arise during the property acquisition phase.

To minimize risks, always plan the transaction carefully. Ideally, the sale of the existing property and the acquisition of the replacement should be closely aligned. For example, if you're selling an auto repair shop worth \$1.5 million, ensure that the ensuing investment is already in the pipeline. This foresight provides a buffer against unexpected challenges, maximizing the allotted 180 days.

The 1031 exchange might sound daunting at first, but with proper guidance and proactive planning, it can be a seamless experience. Consulting a qualified intermediary can further smoothen the process.

So, what about the impending tax bill? The 1031 exchange allows for deferral but not complete evasion.

Essentially, the gain from your initial sale is incorporated into your new property's value. While it might sound complex, what most investors seek is the postponement of the tax.

A strategic use of the 1031 exchange is in estate planning. Holding onto a property acquired through the 1031 exchange for the rest of your life eliminates tax liabilities for whoever inherits it. This rule has paved the way for generational wealth transfers, allowing assets to appreciate over lifetimes without incurring taxes.

The 1031 exchange offers investors a dynamic tool to optimize their real estate investments, allowing for strategic growth, flexibility, and tax deferment. However, it's crucial to approach it with care, intent, and foresight.

9

Driving Towards Green Incentives: EV and Solar Tax Credits

In the world of transportation, electric vehicles (EVs) have steadily gained traction, with financial incentives being a key driver. Tax credits, often seen as a government's tool to encourage eco-friendly efforts, have played a pivotal role in tempting consumers towards EVs.

Initially, obtaining these credits was quite simple: Buy an EV and claim the incentive. Yet, as the industry evolved, so did the regulations.

2023 saw some key changes:

- ➔ **Income Restrictions:** Couples earning below \$300,000, and singles below half that amount, could claim the benefit.
- ➔ **Price Caps:** Depending on the vehicle type, a set Manufacturer's Suggested Retail Price (MSRP) limit was established to qualify for credits.
- ➔ **Used EVs:** A niche within the market, used EVs offered their own credit structure, centered around vehicle age and price.

But the real game-changer was slated for 2024. Instead of waiting for a tax return, the credit would be available instantly upon purchase. This move aims to stimulate the EV market, potentially changing how consumers approach EV buying.

As we champion sustainability, navigating these financial pathways becomes essential. While tax incentives can indeed sweeten the EV deal, a meticulous approach is necessary to maximize the benefits.

Exploring Commercial EV Charging Credits

In recent years, the government has introduced incentives for the installation of commercial electric vehicle (EV) charging stations. These credits, part of

the 2022 Inflation Reduction Act, mirror the structure of solar credits. Businesses that set up EV charging stations can qualify for a 30% credit on the installation cost, as well as the ability to write off the entire expense.

However, geographical limitations may affect your eligibility for these credits. It's crucial to confirm whether your location falls within the approved area for these incentives. The installation of EV charging stations is still relatively uncommon, and the process can be influenced by your utility company's policies and your state's regulations.

Disclaimer: As of the publication date, the information provided here is accurate. However, tax laws are subject to change, so it's essential to consult current regulations or seek professional advice before making any decisions.

The Shifting Landscape of Solar Energy Credits

Just like electric vehicle (EV) credits, solar energy credits are subject to constant change. Unlike the complex calculations and strategies often associated with EV credits, obtaining solar or renewable energy credits is relatively straightforward. Essentially, if you invest in solar panels, you are eligible for the credit. However, it's important to note that the term "renewable energy credits" encompasses more than just solar energy; it also includes wind, turbine, and

other renewable sources. In practice, solar energy credits are the most common and widely used.

In essence, claiming solar credits boils down to two critical factors:

1. Where you are installing solar panels
2. How much was invested in the installation

Remarkably, the process remains nearly identical for both personal and business applications. It hinges on the total cost of the installed system. You don't need to worry about calculating the panel costs or factoring in labor expenses; the credit encompasses the entire installation cost, from start to finish. Suppose your solar panel installation amounts to \$50,000. In that case, you are eligible for a 30% federal tax credit, mirroring the structure of EV credits.

However, as previously discussed, the process of claiming this credit and reaping the tax benefits is not instantaneous. Your reward comes in the form of a tax credit on your annual tax return. So unless you begin your solar panel installation towards the end of the year, you may have to wait several months to receive your tax savings. The timing of your installation relative to your tax filing can significantly impact when you see the credit.

It's essential to clarify that solar credits, like EV credits, are non-refundable. In other words, if your total tax liability is less than the credit amount, you

won't receive a refund for the difference. If your tax liability is only \$10,000, you won't get a \$5,000 refund for the unused credit. However, there is a silver lining: these credits can carry forward for up to five years. This safety net ensures that you won't lose out on your investment if you can't utilize the full credit in the first year.

Now, let's address a hypothetical scenario where you install a large solar panel system, potentially worth hundreds of thousands of dollars. For these substantial installations, the credits can amount to tens of thousands of dollars, which can significantly impact your tax bill. Yet, the credit's non-refundable nature means you'll need substantial tax liability to fully benefit from it over the next five years.

Solar credits present a fairly straightforward path to savings. However, the key to maximizing their impact is understanding your tax liability, the timing of your installation, and the potential for credit carryforward.

Personal vs. Business Applications

Solar energy credits are available for both personal and business use, but there are differences between the two.

Personal Installations: Residential solar installations are generally smaller in scale, with fewer panels designed to meet the household's energy needs. However, there are limitations that can affect your

return on investment. Homeowner associations, for instance, may restrict solar panel installations for aesthetic reasons. Additionally, the orientation and size of your roof can impact the efficiency of your solar panels. In residential settings, the goal is often to eliminate the entire utility bill, not just reduce it.

Business Installations: Commercial properties have a different energy profile compared to residential ones. They typically require larger solar installations to meet their substantial electricity demands. This can lead to a more significant return on investment for businesses, as they can eliminate or drastically reduce their utility bills. The efficiency and financial benefits are more favorable for businesses, making solar energy a compelling option for commercial properties.

Assessing Return on Investment

As with any financial endeavor, evaluating the return on investment (ROI) of solar energy requires careful consideration. There are two primary factors to weigh:

1. **Tax Savings:** The federal tax credit for solar energy, combined with potential state-level incentives, can significantly reduce the upfront cost of your solar installation. Understanding the tax implications and accurately projecting your tax liability is crucial to maximize these benefits.

- 2. Utility Bill Savings:** The ultimate goal of a solar installation is to offset or eliminate your utility bills. This ongoing monthly savings can contribute to your ROI, making solar energy an attractive investment, particularly for businesses with high electricity consumption.

When calculating your ROI, consider your specific circumstances, such as your location, energy usage, and the size of your installation. It's crucial to assess the potential long-term savings against the upfront costs, including any financing or lease payments.

The Changing Landscape of Energy Efficiency

The landscape of residential energy efficiency has evolved over the years. Today, many homes are built with energy-efficient features, reducing their overall energy consumption. This change has implications for solar installations, as the utility bills of newer homes are often lower than those of older, less energy-efficient houses.

Unlike in the past, when energy-efficient homes were a rarity, today's homes typically feature improved insulation, thicker walls, and airtight designs. These advancements result in lower utility bills, reducing the financial incentive for solar installations in some residential settings. While solar panels can still be a

valuable addition, the financial impact may be less pronounced.

The Role of Battery Systems

Battery systems, which store excess energy generated by solar panels, have gained attention as a means to further optimize solar energy use. While not as common as solar installations, these systems offer the potential to store surplus energy for use during cloudy days or at night, reducing reliance on the grid.

However, it's worth noting that not all regions and utility companies support the use of battery systems. Regulations and restrictions can vary, limiting your ability to sell excess energy back to the grid or store it for future use. Consider the compatibility of battery systems with your local energy landscape before investing in one.

10

The Single Best Tax Deduction

Every year, as the tax season approaches, clients call or email with the same urgent question "Hunt, how can we lessen our tax liabilities from the previous year?" or "What future steps can be taken to ensure we're not overpaying to the IRS?"

A frequent topic of conversation, especially during tax season, is how interesting it is that prominent figures like Jeff Bezos or Elon Musk seemingly pay a lower tax rate compared to the average American. While this may be an oversimplified representation in the media, what's imperative to understand is that tax strategies

differ significantly depending on your income bracket. Certain strategies are tailored for those with an AGI in the millions, simply because implementing such tactics isn't always cost-effective for those earning less.

Now, for the common American or the self-employed business owner, retirement accounts stand out as the single best tax deduction. What's intriguing about retirement accounts is their unique advantage. You essentially gain a deduction by allocating money for your future self. Unlike other expenses where the money is no longer yours, with retirement accounts, the invested amount remains yours and grows under tax deferment.

Before we get into all the details of the various retirement account options, I want to be clear: The insights presented here aren't definitive financial advice, nor are they retirement advice that fits your unique situation. My expertise lies in accounting. My goal is to equip you with knowledge about the different options available so that you can have an informed discussion with financial professionals.

Don't forget that tax professionals and retirement advisors often team up. They work together to come up with tax saving game plans. This cooperative approach extends to lawyers as well. For instance, when considering entity restructuring or expansions, while a lawyer offers legal insights, they may not address tax implications. Similarly, a financial

planner's advice is much better when they know about your tax situation.

Diverse Retirement Account Landscape

The world of retirement accounts is vast, with options like IRAs and 401Ks. In my experience, while we've frequently explored the benefits of pre-tax contributions in accounts like traditional IRAs and 401ks, it's equally important to understand the appeal of post-tax contributions.

The primary appeal of traditional IRAs and the like lies in their tax-saving aspect. However, Roth IRAs and Roth 401ks, while offering no immediate tax deductions, are intriguing in their own right. The fundamental difference is in how contributions are treated tax-wise. With a Roth IRA, you make contributions with after-tax dollars. This means that while you don't get upfront tax breaks, the IRS largely remains hands-off, provided you stick to contribution limits.

One of the standout features of Roth accounts is their inherent flexibility. Consider this scenario: Imagine investing a substantial amount in a regular 401k and realizing you need to withdraw some money before hitting the retirement age due to unforeseen circumstances. Such premature withdrawals not only attract taxes but also early withdrawal penalties.

In contrast, Roth 401(k)s allow you to withdraw your contributions (though not earnings) without penalties or taxes. This offers a safety net of sorts for those unsure about locking their funds entirely.

Personal Retirement Options: Traditional IRA vs. Roth IRA

On a personal front, there are two primary retirement avenues: Traditional IRA and Roth IRA.

Let's compare investing in a traditional IRA to a Roth IRA. Consider investing \$5,000 into both. The traditional IRA offers immediate tax benefits, but upon withdrawal during retirement, you face taxes on your contribution and its earnings. Conversely, the Roth IRA provides tax-free withdrawals during retirement, even if you forego immediate tax deductions.

This difference is critical when considering tax brackets both now and during retirement, especially given the unpredictable nature of future tax policies.

Traditional IRA: This is the quintessential retirement plan. With the flexibility to contribute up to \$6,000 annually (or \$7,000 if you're over 50), a traditional IRA provides immediate tax deductions. Furthermore, the money in this account grows tax-deferred until retirement. However, it's vital to exercise caution.

Early withdrawals before the age of 60 invite not only taxes but also a 10% penalty.

Roth IRA: Unlike its traditional counterpart, Roth IRA contributions don't qualify for immediate tax deductions. However, it offers increased liquidity. The amount you contribute can be withdrawn anytime without penalties or taxes, though the gains need to stay put until retirement. The catch is that there are income restrictions. If your earnings exceed a certain threshold, direct Roth IRA contributions are off the table.

The Power of Roth IRAs: Decoding Peter Thiel's Strategy

Peter Thiel's (cofounder of PayPal) story is like a masterclass in using the Roth IRA to your benefit. As an early investor in tech giants like PayPal, Google, and Facebook, Thiel's perspective on taxation was unconventional. His Roth IRA is rumored to be one of the most valuable, highlighting how influential individuals strategically leverage tax rules to their advantage.

In the year 2020, financial records revealed an astounding fact: Peter Thiel's Roth IRA had skyrocketed in value to approximately \$5 billion. What was even more shocking was that back in 1999, it had only been worth \$2,000. But how did such an exponential growth occur in just two decades?

Understanding the Roth IRA Phenomenon

Many might wonder, considering the annual contribution limits of a Roth IRA, how someone could accumulate billions. If you were to consistently contribute the maximum amount year after year, you'd still fall significantly short of the 5-billion-dollar mark.

The secret behind Thiel's strategy lies in his investment background. Known as a venture capitalist, Thiel's primary interest is in startups. Unlike ordinary investors who look for steady and consistent returns, venture capitalists shoot for the stars. Instead of expecting to double their investments, they look for returns in the order of hundreds of times their original stake.

The flexibility of a Roth IRA allows its holder to invest in a variety of assets, including both private and public companies. Thiel, leveraging this flexibility, made strategic investments using his Roth IRA instead of his personal or company funds.

Imagine investing just \$1,000 into an early-stage startup, purchasing a million shares at \$0.001 each. Now, envision that the startup is PayPal, and upon its IPO (initial public offering), each share's value rises to \$50. Suddenly, your Roth IRA isn't just worth a thousand dollars—it's worth \$50 million.

Tax Implications and Public Outrage

When the news of Thiel's Roth IRA value broke out, it was met with mixed reactions. The main advantage of a Roth IRA is that all distributions are tax-free. So, if Thiel were to withdraw his entire IRA worth, he wouldn't owe the government a dime in taxes.

This strategy has raised eyebrows, as it seems like a tool for the wealthy to bypass the tax system. While the average individual might struggle to find similarly high-return investments, even modest investments in a Roth can prove beneficial due to their tax advantages.

For instance, if one were to gain \$5,000 in a regular brokerage account, they might have to pay a significant amount in short-term capital gains tax. Conversely, gains within a Roth IRA remain untaxed as long as they stay invested.

The Roth IRA: A Tool Beyond Thiel

There's another dimension to the Roth IRA that few consider: setting up accounts for children. While minors often don't have earned income (a prerequisite for contributing to a Roth IRA), those who earn a salary—say from a family business—can benefit greatly from an early start.

For example, if a child earns \$6,000 annually from a family business, that money could be channeled into a

Roth IRA. Over time, this strategy can create a sizable nest egg for the child's future, be it for education, marriage, or even retirement.

The case of Peter Thiel's Roth IRA, though an outlier, underscores the importance of strategic financial planning. While it's possible to manage personal finances or even business accounts independently, it's often beneficial to seek professional guidance. An expert's insights can unlock opportunities and strategies you might have never considered.

A wise adage says, "It's the who, not the how." It's not about becoming an expert in everything but finding one. Thiel's Roth IRA is a testament to this philosophy. He leveraged both his expertise and the tools available to him to maximize his financial potential, reminding us all of the importance of strategic planning and professional guidance.

It's pivotal to remember that while accountants like me can provide guidance on tax implications, investment decisions should ideally be discussed with a financial advisor. Your retirement strategy should balance pre-tax and post-tax benefits, keeping in view your current earnings, anticipated future income, and your retirement goals. While it may seem tempting to navigate these waters alone, a financial advisor's expertise can be invaluable. Especially when dealing with complex maneuvers like the Backdoor Roth conversion for high-income individuals, professional

advice ensures you're making the most of your money without unintended missteps.

Exploring Business Retirement Accounts: Simple IRA vs. 401(k)

When evaluating retirement plans, I usually like to analyze Traditional IRA first. Meanwhile, a Roth IRA demands scrutiny to figure out if it fits the bill. Though these two provide solid individual options, the business side offers more enticing alternatives. For businesses, two leading retirement account choices are the Simple IRA and the 401(k). Here's a breakdown of each:

Simple IRA: Simplicity at its Best

Why it's Popular

Businesses prefer the Simple IRA because, true to its name, it is uncomplicated, cost-effective, and straightforward to establish.

Setting It Up

A Simple IRA requires initiation through your business. This means consulting a financial advisor, a bank, or even certain insurance companies.

Contribution Limits (2022)

For individuals below 50, the cap stands at \$14,000 per year. Those above age 50 can contribute up to \$17,000 annually.

Matching Contributions

Businesses can match up to 3% of an employee's compensation, enhancing the contribution potential.

Tax Implications

Let's illustrate. By injecting \$20,000 into a Simple IRA, you might save \$5,000 to \$6,000 in taxes, depending on your jurisdiction.

Employee Benefits

Offering a Simple IRA can be advantageous to employees as well. Typically, businesses offer a 3% match. For instance, if an employee earning \$50,000 contributes \$6,000, the business matches \$1,500 (3% of their salary).

A Note of Caution

Withdrawing funds before full retirement age can attract taxes and penalties. It's essential to understand that this is a long-term commitment.

401(k)

Step Up Cost Implications

The 401(k) generally incurs more fees than the Simple IRA, ranging between \$3,000 to \$5,000 annually. It's essential to weigh the costs against the benefits.

Contribution Limits

Under age 50 can contribute \$20,500. Those above 50 have a limit of \$27,000.

Employee Offerings

The 401(k) provides flexibility in matching structures. For instance, you might offer a dollar-for-dollar match up to 3% and a 50-cent match up to 6%.

Additional Features

For those looking to maximize contributions, a profit sharing plan or a cash benefit plan can be incorporated into the 401(k).

Deciding between Simple IRA and 401(k)

If you're planning modest contributions, a Simple IRA might be ideal due to its lower fees. However, for those looking to maximize their retirement contributions, the 401(k) offers more room to grow. As a business owner, understanding retirement options is crucial not just for tax savings but also for securing your future and that of your employees. For those starting on this journey, beginning with a Simple IRA is advisable. As the business evolves and needs change, transitioning to a 401(k) can be the next logical step.

1. The 401(k) Landscape

If your business lacks a 401(k) structure, it's high time you set one up. However, for businesses that already have one in place, periodic check-ins with the right people are key to making sure you're using it the right way.

2. Weighing the Simple IRA vs. the 401(k)

For entrepreneurs who have a simple IRA, talking to a financial expert about transitioning to a 401(k) might be wise, especially if there's an interest in making Roth contributions. While every financial solution has its pros and cons, it's essential to have these conversations.

Misconceptions about Financial Advising

Contrary to popular belief, if a financial advisor hasn't steered you towards a particular strategy, it doesn't necessarily mean they're overlooking your interests. Sometimes, certain financial tools might not align with your goals, or the product might not be a fit for your situation.

Moreover, Roth contributions, though beneficial, are not as common. This is not due to their lack of merit but more because of their unfamiliarity. Hence, talking with a financial advisor about your contribution approach can be helpful.

Bottom Line

Retirement planning isn't just about saving; it's about optimizing your contributions, understanding the complexities of available tools, and making informed decisions. Whether you're leaning towards a traditional path or exploring the Roth avenue, staying

informed and proactive can ensure a secure financial future. Always remember, the right choices today can lead to a prosperous tomorrow.

For up-to-date contribution limits, please visit:

<https://www.irs.gov/retirement-plans/plan-participant-employee>

11

Deciphering Tax Deadlines

When fall approaches, it's time to start thinking about the deadline for extended business and personal taxes. This season offers an opportune moment to look back on the year and to anticipate what lies ahead.

How can you strategize or minimize taxes without understanding your present financial situation?

There's a lot of varying opinions on the benefits of tax extensions. Some might say, "I'll wait until the September or October deadline to file my taxes. This

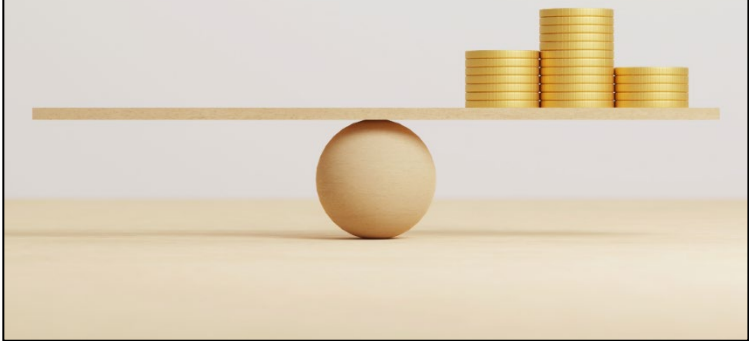
will surely decrease my risk of an audit!" Others might procrastinate, arguing the tediousness of gathering tax documents. They often resort to postponing the inevitable, saying, "Extend my deadline. We'll tackle this in the fall." But sometimes, it's not a personal choice. Many are frustrated with accountants who habitually extend the deadline despite being provided with all the necessary documents early in the year.

It's essential to debunk some myths surrounding extensions. Often, accounting firms intentionally extend a chunk of their client's tax returns. Their rationale is workload management; they might be swamped during the typical two to three-month tax season and wonder how to sustain business throughout the year. However, such practices can be detrimental. When accountants opt for extensions without a valid reason, clients who owe money might end up facing penalties for late payments.

There's a widespread belief that tax extensions somehow lower audit risks. The argument is similar to hiding your test paper among a thousand others in college, hoping it gets overlooked. This might have been somewhat possible in an era of paper tax returns. But now, in our digital age, all tax returns are electronically filed. The theory of "hiding in the crowd" doesn't stand.

More than anything, unnecessary extensions stall the process of future planning.

"Remember, an extension
to file your tax return
doesn't extend the time to
pay your taxes."



While it's possible to make a basic projection for the next year without finalizing the current year's taxes, it lacks authority and precision.

So, what is the ideal approach? Tax planning is most effective when done proactively, not when rushed during tax season. It's about engaging with your accountant, understanding the nuances of your financial situation, and making informed decisions. If

you're unsatisfied with your accountant's services or they're unwilling to assist with tax planning, consider seeking a more proactive professional. The true value of a proficient accountant is not just in the transactional task of preparing a tax return, but in their ability to offer guidance and forward-looking insights.

To navigate the tax maze, arm yourself with knowledge and tools. Our firm uses client data from at least seven months of the year to make detailed tax estimates. This includes forecasting both business and personal taxes, accounting for income from all sources, and taking personal deductions into consideration.

An Introduction to Financial Forecasting

Understanding your financials is paramount. Take an example where eight months into the year, the financial records show a net income that provides a solid foundation for predicting the rest of the year's financial trajectory. If your shop shows a net profit of \$70,000 through July, this roughly translates to \$10,000 monthly profit. Projecting this pattern, the year-end might show an estimated net income of about \$120,000.

Income Considerations and Tax Planning

Understanding your revenue flow is a must. For instance, if one significant income in the first half of the year is due to a one-time sale (like a piece of equipment), it shouldn't be projected for the entire year. Thus, while a \$70,000 income by July sounds promising, if \$40,000 came from such a sale, then the genuine operational profit might be much lower.

One-time incomes or expenses need to be factored in. For instance, if you had to pay a hefty amount due to a sales tax audit, then that shouldn't be expected as a regular business expenditure.

Retirement and Capital Improvements

Planning for the future is as vital as managing the present. Retirement plans, capital improvements, and large equipment purchases must all be considered. Purchasing a high-value machine, for instance, can be written off in the first year, potentially offsetting tax liabilities.

For more information, see Chapter 7 – Handling Big Purchases on page 59.

Holistic Tax Planning

Tax planning doesn't end with business profit and expenses. Supplementary incomes, like rentals or a

spouse's income, should be integrated into the broader tax planning framework.

A Sanity Check

Forecasting and planning don't replace the need for a competent accountant. However, they can provide a preliminary idea of the financial health of the business. Changes in profit margins, small or large, should prompt further discussions with your accountant.

Proactive Strategies for the Modern Shop Owner

It's crucial to have an understanding of numbers and percentages. As a rule of thumb, consider the 25% mark. For instance, if you find that your profits have risen by \$50,000 compared to the previous year, it's wise to reserve an additional \$12,000 to \$13,000 to accommodate that increase. This ensures your finances remain in a favorable position. Even if you slightly overestimate, you'll find comfort in knowing you've taken precautionary steps.

But what if you're experiencing unprecedented growth, much like several of my clients? Doubling or even tripling your income mid-year calls for an early adjustment. If your accountant doesn't automatically provide a tax estimate, it's a red flag. The need to understand your financial position is vital.

Remember, if you're feeling uneasy, reach out to your financial team. Good financial teams will constantly monitor their clients' numbers for accuracy and any significant fluctuations. If they spot any big changes, they'll act quickly, figuring out the best moves to save and plan ahead.

Estimated Payments

Increased earnings usually translate to larger estimated tax payments for the remainder of the year. This could mean setting money aside, making larger payments, or finding a balance between the two. The key question many ask is, "Do I truly need to make these estimated payments?" The short answer: Absolutely.

To provide clarity, imagine owing \$100,000 in tax. If you choose to pay the entire amount on the deadline, penalties for underpayment of estimated taxes will ensue. The IRS prefers staggered payments throughout the year. The actual formula they use is complex, but in essence, it balances your previous year's payment against your current year's expected dues. Avoiding underpayment penalties, even if they seem minor, can save you a significant amount over time.

When managing taxes, understanding the options is essential. For example, while you could make quarterly payments, the IRS is also content with you

adjusting the withholding on your weekly paycheck. For smaller liabilities, you might avoid estimated tax payments altogether by merely increasing withholdings.

Paying taxes, while universally unwelcome, is a sign of profitability. If you're not concerned about adjusting your withholdings or making estimated payments, it may indicate a lack of profit – a situation no business owner wants to be in.

In tax planning, the most effective approach considers the broader business landscape. Before making large investments or expenditures to minimize tax liability, evaluate the genuine need and potential ROI. Spending for tax benefits alone is counterproductive.

Remember: while you save 25 cents on the dollar with tax deductions, you're still out by 75 cents on that dollar.

Timing is another critical factor. Suppose you've earmarked \$40,000 for parking lot renovations but anticipate lower income this year. It might be wise to defer the expenditure, benefiting from higher tax brackets in the subsequent year. Conversely, if facing a significant tax bill, consider advancing planned expenditures to leverage immediate tax benefits.

For more information, see Chapter 7 – Handling Big Purchases on page 59.

Bottom Line

Financial forecasting is an invaluable tool for shop owners. Proper tax planning, understanding of income flows, and preparing for future expenses are crucial components of effective business management.

This task shouldn't rest solely on your shoulders - it's essential to collaborate with financial professionals to ensure accuracy and compliance. Your peace of mind and financial health depend on it.

GLOSSARY

Understanding tax terminology is crucial for business owners, including those running auto repair shops, to navigate tax season effectively. Here's a list of essential tax terms that could come in handy:

Adjusted Gross Income (AGI):

Your total income including sales, minus certain adjustments. It's the starting point for calculating your tax bill and eligibility for deductions and credits.

Business Expenses:

Costs incurred during the business operation. These can be deducted from your income to lower your tax liability, provided they are necessary and ordinary for running your auto repair shop.

Capital Assets:

Significant pieces of property such as equipment or real estate, used to improve your business and often subject to depreciation over several years.

Depreciation:

The decrease in value of your capital assets over time. You can deduct the cost of this decrease each year.

Estimated Tax Payments:

Quarterly payments made to the IRS by self-employed individuals or corporations based on their expected income or profit for the year.

Filing Status:

Indicates your tax-filing group, based on your marital status and family situation. It affects your tax rate and how much you can claim in deductions.

Gross Income:

The total amount your business earned before any costs or expenses are taken out.

IRS Audit:

A review of your accounts and financial information to ensure information is reported correctly according to tax laws and to verify the reported amount of tax is correct.

Net Income:

Your business's profit after all expenses, including taxes, have been paid.

Payroll Taxes:

Taxes required to be paid by employers and employees, calculated based on the salaries and wages of employees. These include Social Security and Medicare taxes.

Quarterly Taxes:

Payments made to the IRS four times per year to cover income tax and self-employment tax.

Schedule C:

The tax form filed by sole proprietors to report income or loss from a business.

Section 179 Deduction:

Allows businesses to deduct the full purchase price of qualifying equipment and/or software purchased or financed during the tax year.

Self-Employment Tax:

The tax consisting of Social Security and Medicare taxes primarily for individuals who work for themselves.

Standard Deduction:

A specific dollar amount that non-itemizers may subtract from their income before income tax is applied.

Tax Credit:

A tax incentive that lets you subtract a certain amount from your tax liability.

Tax Deduction:

An expense you can subtract from your taxable income, reducing your tax liability.

Taxable Income:

The amount of income used to calculate how much tax an individual or business owes to the government in a given tax year.

Withholding:

A portion of an employee's wages paid directly to the state or federal government by the employer, used to cover the employee's tax liability.

These terms represent just the tip of the iceberg when it comes to tax vocabulary, but they cover many of the basics that auto repair shop owners will encounter. It's always a good idea to consult with a tax professional to understand how these terms apply specifically to your business situation.

TAX DEADLINES

Tax deadlines can vary depending on the tax forms you're required to file and whether you're operating on a calendar year or a fiscal year. Below are the standard tax deadlines for individuals and various types of businesses operating on the calendar year in the United States. However, be aware that these deadlines can change, and there may be additional deadlines for other forms or obligations not listed here. It's always a good idea to check with the IRS or a tax professional for the most current information.

For Individuals (Form 1040):

April 15: The standard deadline to file individual tax returns (Form 1040) for the previous year. It's also the deadline to pay any tax due.

For C Corporations (Form 1120):

April 15: Deadline for C corporations to file corporate tax returns (Form 1120) for the previous year. If the due date falls on a weekend or holiday, it may be extended to the next business day.

For S Corporations (Form 1120-S) and Partnerships (Form 1065):

March 15: S Corporations and Partnerships typically have to file their returns by March 15.

For Quarterly Estimated Taxes (Form 1040-ES):

April 15: First quarter estimated tax payment due.

June 15: Second quarter estimated tax payment due.

September 15: Third quarter estimated tax payment due.

January 15 (following year): Fourth quarter estimated tax payment due.

Extensions:

If you can't meet the standard deadline, you can request an extension. For individuals and C corporations, this typically gives you until October 15 to file your return. However, note that an extension to file is not an extension to pay taxes owed — you're still required to estimate and pay what you owe by the original deadline to avoid potential penalties.

Other Deadlines:

There are various other tax deadlines throughout the year, depending on your specific circumstances. These may include deadlines for state taxes, payroll taxes, sales taxes, and specific forms or disclosures related to international transactions or assets.

COVID-19 and Other Circumstances:

In the past few years, certain deadlines have been extended due to the COVID-19 pandemic. Additionally,

the IRS sometimes extends deadlines for those affected by natural disasters.

Always confirm these dates each tax season, as they can shift if a date falls on a weekend or a holiday, and there can be additional state-specific deadlines.

Because of the complexities involved, especially for business taxes, working with a tax professional is often advisable.

TAX PREP CHECKLIST

1. Gather Your Financial Records:

- Income statements (Profit and Loss statements)
- Balance sheet
- Cash flow statements
- Previous year's tax return (for reference)

2. Organize Receipts and Invoices:

- Sales receipts and invoices
- Expense receipts (categorized: utilities, rent, supplies, etc.)
- Travel and entertainment expenses
- Asset purchases (equipment, vehicles, etc.)

3. Employee and Contractor Information:

- W-2 forms for employees
- 1099 forms for contractors
- Payroll summaries
- Benefits, commissions, bonuses, etc.

4. Account for Deductible Expenses:

- Inventory costs
- Business insurance
- Health insurance premiums
- Retirement contributions
- Depreciation schedules for assets

- Home office expenses (if applicable)

5. Reconcile Financial Statements:

- Cross-check major transactions
- Verify bank account statements
- Reconcile bookkeeping records with bank statements
- Address any discrepancies

6. Review Business Structure and Changes:

- Confirm your current business structure (sole proprietorship, partnership, LLC, corporation, etc.)
- Document any changes in your business (ownership, address, structure)

7. Charitable Contributions:

- Receipts for charitable donations
- Documentation of non-cash contributions

8. Interest and Tax Payments:

- Mortgage interest statements
- Business loan interest statements
- Records of estimated tax payments made during the year

9. Coordinate with Professionals:

- Consult with your accountant or tax professional early

- Update them on any significant changes in your business
- Ask about new tax laws or deductions that may apply to you

10. Prepare Financial Reports:

- Finalize year-end financial reports
- Create a summary of income and expenses
- Analyze your financial performance compared to previous years

11. Set Aside Funds for Tax Payments:

- Estimate potential tax liability
- Ensure you have funds allocated for tax payments

12. Check Deadlines and Compliance:

- Note the tax filing deadline
- Understand extensions, if needed
- Check for specific state requirements or obligations

13. Plan for the Next Tax Year:

- Reflect on the current tax year for areas of improvement
- Consider tax planning strategies for the next year
- Evaluate the need for more regular financial check-ins or adjustments in bookkeeping practices

14. Secure Data:

- Ensure all sensitive financial data is securely stored or archived
- Use encrypted digital storage solutions to protect against data loss

Remember, each business is unique, so this checklist should be adapted to fit your specific circumstances, legal obligations, and operational practices. It's also prudent to engage with a tax professional to ensure all bases are covered, especially for nuanced or complex financial scenarios.

ABOUT THE AUTHOR

Hunt is Accredited in Business Valuation and a licensed Certified Public Accountant that has been with the firm since 2006. He specializes in business taxes, valuations and does consulting work with our clients all across the country. When he's not in the office, Hunt enjoys spending time with his family, golfing, working on and racing his cars.

ABOUT PAAR, MELIS & ASSOCIATES

Paar Melis is an expert accounting and tax partner for automotive repair shops. As a leading accounting and tax company with over 30 years of experience in the automotive repair industry, we are your trusted experts in handling the unique financial challenges that your business faces. At Paar Melis, our team of skilled accountants and tax specialists knows the ins and outs of the automotive repair sector. We've mastered the complexities of accounting for repair shop operations, inventory management, revenue recognition, and tax compliance, among other critical aspects.



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Podcast

Join Hunt weekly as he discusses the financial side of owning an auto repair shop, helping shop owners nationwide develop a core understanding of their shop's financials.



Book

Hunt's under the hood look into the financial side of running an auto repair shop. Learn to master your numbers and take your shop to the next level.



These resources and more can be found on our website
www.paarmelis.com.

Wrenches to Write-Offs is an invaluable resource for auto repair shop owners, diving deep into the specifics of financial management during the critical tax season. This book is tailored specifically for the automotive repair industry addressing unique challenges and opportunities shop owners face when dealing with taxes.

Hunt emphasizes the importance of professional advice, suggesting when and how to seek help from tax professionals, accountants, or financial advisors. It acknowledges that while the book provides a robust foundation, each auto repair shop has unique financial circumstances warranting expert advice.

Concluding with a resourceful appendix, the book offers a checklist for tax season preparation, key tax deadlines, and a glossary of essential tax terms that auto repair shop owners should understand.

Wrenches to Write-Offs serves not just as a seasonal guide but as a reference that auto repair shop owners can turn to year after year.

Hunt Demarest is Accredited in Business Valuation and a licensed Certified Public Accountant that has been with Paar Melis since 2006. He specializes in business taxes, valuations and does consulting work with clients all across the country.

