Jumping Financial Hurdles

Learn how to avoid additional tax pitfalls for your garden center in the second part of this 2-part series.

By
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Last month, we began talking about the various taxes retailers should know about, be wary of and seek competent counsel to handle well. We discussed charitable deductions, sales tax, bad debt and use tax. Now, let's look at other financial hurdles you may face.

Estate Taxes

There is no more fatal mistake than to craft your exit strategy around the lowest estate tax. It's a complicated field and one that changes almost every time Congress meets. Do you think it makes sense to gift (or sell) pieces of your company over time to shift the assets to the next generation before the assets greatly appreciate? Wrong! The graveyard of dead garden centers is full of companies in which kids with varying interests all ended up with ownership positions. Those who wanted to work and grow the company had different needs and goals than those who wanted cash now. Long-term estate planning can't take into consideration who will be working in the company five or 15 years from now.

Additionally, Congress will be changing these laws, and your estate plan may not be able to change with the new laws. Estate planning requires professional assistance. Get good counsel and ask them about life insurance to fund any estate taxes. In many situations, that is a better option than putting the company at risk in an effort to avoid paying estate taxes.

Shifting Income

Do you remember the Justice Learned Hand decision we talked about last month?: "Anyone may arrange his affairs that his taxes shall be as low as possible" This sometimes gives rise to putting family on the payroll to put income into the kids' hands at a lower tax rate and, at the same time, give the company a deduction. This is bad for a number of reasons. By the time you pay FICA, FUTA, Medicare, etc., the savings may not be as great as you thought.

First, transferring assets in this way trains the kids to do little or nothing and, in return, expect money from the company. What kind of good management lesson is this? Second, you have to be aware of the "kiddie tax" that may also come into play here. While not a specific tax, the so-called kiddie tax refers to the limitations the government puts on income earned by children under the age of 14 and, therefore, taxed at a much lower rate. At this time, income more than $2,100 earned by someone younger than 14 is taxed at the parents' adjusted rate.

There's another form of potentially dangerous income shifting that moves income or expenses from one accounting period to another. Granted, in some circumstances, this can be advantageous. If you have a low-profit year, it could be beneficial to generate more profit because it will be at a lower tax rate. Sometimes this can be done by changing your depreciation methods or even your accounting accrual methods. Sometimes there are things you can do with key clients to accelerate (or postpone) income from one tax year to another. This isn't a "do it yourself" project. Get competent tax help.

Related Party Transactions

Related party transactions refer to transactions between the company and the controlling shareholders or their families. The most common scenario in our industry happens when the garden center or greenhouse is operated by a corporation that rents its facilities from a landlord controlled by shareholders of the operating company. When the two entities have different shareholders, conflicts can develop. So if the two ownerships aren't completely the same,

From estate taxes to shifting income, there are many financial hurdles you need to consider in regards to your business's taxes.

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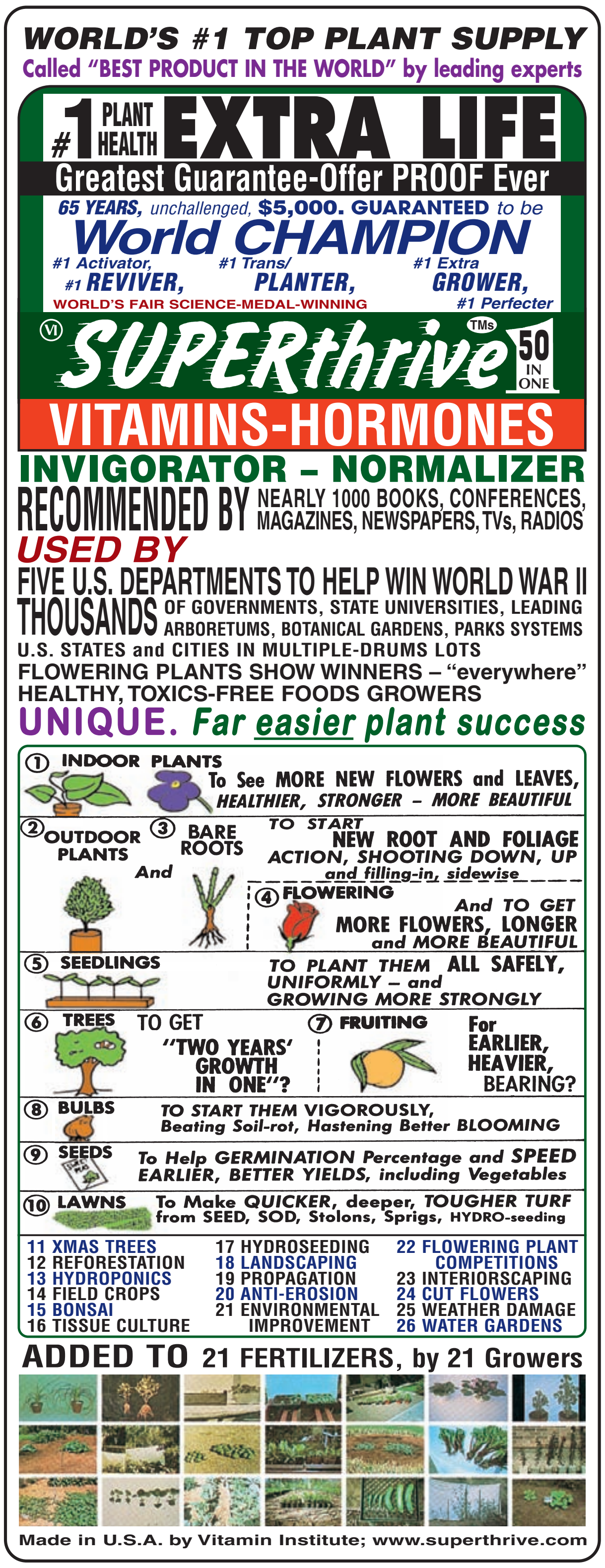

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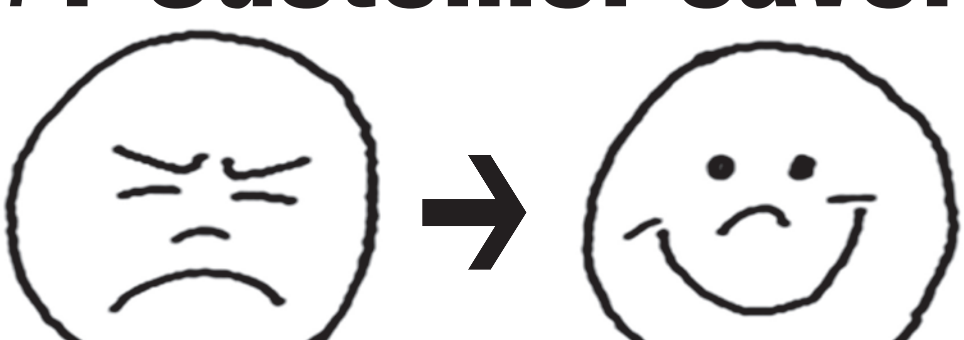

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it's best to have all documents and relationships between the two entities clear, written and fully discussed.

From the tax perspective, this type of relationship is perfectly legal so long as there is a true business purpose. Occasionally, a close relationship between the two entities can allow for creative solutions to difficult situations.

One client of ours thought he was a retailer. Over the years, he had been growing or bringing in more and more product for a wholesale account. He woke up one June morning realizing one wholesale account was now 20 percent of his total business. He got this rude awakening when this major customer wasn't paying its bill and then was bought by a national chain that terminated the relationship with zero notice. Our client was left holding a bad accounts receivable and specially grown inventory, which he had no way to effectively liquidate on short notice.

He knew he would have a loss for the tax year and a very tough cash flow crunch through the next spring. He immediately drew up a new budget and cash flow projection based on the loss of this major client. We suggested he immediately meet with his banker. He asked for his long-term loan to be rewritten for interest only for the next year. After some negotiations, the banker was agreeable. Then the operating company went to the family partnership from which the garden center leased the land and buildings and asked to renegotiate the rent. As a result, the operating company paid no rent for eight months. The amount owed plus an amount for interest would be repaid by increasing the rent for the next three years thereafter.

What this did was give the garden center more cash for the immediate time period. As a by-product, it reduced the individual family members' income tax load for the year by shifting the income to future years.

In some cases, the Internal Revenue Service (IRS) will look at transactions as "form over substance." This means that if they think your transaction was not business related — or was a "sham" transaction — they will disallow it. In this case, the fact the bank also agreed to a reduced cash flow gave solid credence to the concept of an urgent business need to restructure cash flow obligations.

Loaning Money

There are many legitimate business reasons for individuals related to the company to borrow or loan money to or from the company. These transactions should be done at "fair market value." This means you can neither pay yourself 50-percent interest nor borrow money at 1-percent interest. One benefit of the company borrowing from related parties is that it gives a much better return on cash invested to the related parties than if the money was put into a bank account or certificate of deposit. The downside is that more of the family's net worth is tied up in the business. In other words, there have been a lot of family eggs put in the one company basket.

Occasionally, you find companies that are financially stressed and need the owner(s) to loan the company money. However, the owners continue to draw their existing paychecks even though the company owes them money. Confirm this with any bank covenants, but it makes very little sense to have the company owe you money while at the same time paying you taxable wages. If the company is suffering a short-term cash crunch, rather than pay you wages, have it repay the debt it owes you. That repayment is a non-taxable transaction. Plus, you save payroll taxes.

This will also improve the company's profit position, although it's not an accurate representation of the true costs of running the business. Some will say you should continue to draw a salary because otherwise, despite your efforts, you won't be building personal net worth outside the company. There is some validity to this perspective, so consider taking notes from the company for your deferred wages. Consult with your CPA on how to do this so your personal income taxes are only owed when you actually get the cash.

There are times employees/directors/executives will need/want/deserve cash but don't wish to increase their taxable income. Some companies have loaned money to these individuals since a loan is not a taxable transaction by itself. If you do this, confirm with your CPA what interest you must charge on the loan (yes, I meant "must charge"). An interest-free loan to an employee is normally considered taxable income.

Net Operating Loss Carryback

We had a client who discovered an internal theft last year. More than $100,000 was lost. The books were manipulated to hide the shortage. We met with the accountant and suggested the company file an amended tax return to generate a tax refund of more than $20,000, which would be a very welcome infusion of cash. Their accountant didn't believe it could be done. We also suggested a new accountant. The client followed our advice and got a refund.

Any time you find an error in your books, you should file an amended return. If taxes were paid in the prior years, many times you'll be able to get a quick refund and/or generate a Net Operating Loss Carryback or Carryforward. Again, should the situation arise, these are areas to discuss with your competent accountant.

The Case For Skimming

Despite all the logic and ethics, we still run across the occasional garden center operator who thinks it's fine to do an all-cash delivery for a friend or neighbor and "forget" to ring that sale into the cash register. They think they're making a few "tax free" bucks on the side. Let's call it what it is: tax fraud, not tax free. Ask Stew Leonard, Leona Helmsley or Willie Nelson how "free" it was for them. Currently, actor Wesley Snipes is finding out the hard way that the IRS doesn't treat tax fraud lightly. At this time, he is pleading incompetent tax advisors. Take a lesson.

Despite the potential criminal issues for sales tax fraud and income tax fraud, there are other downsides to these ill-conceived behaviors. If you need to get a bank loan or want to sell the business, you've understated the business profitability. We've had a few prospective clients want to hire us to help them sell their businesses. They grin, give you a wink and say, "There may be more sales than are reported on the financial statements." Our only response has to be, "Well, you can outline to a prospective buyer exactly which sales weren't reported, but know they can take that information to the IRS and get a finder's fee for turning you in. Or you can tell them you commit criminal tax fraud, but you're really an honest guy and they should believe that you only lie to the government. You would never lie to someone who wanted to buy your business."

If you skim your sales, you can't expect a sales price (or borrow money) based on sales you didn't document.

Loss prevention experts will point to a study that showed employees were six times more likely to steal from their employer if they thought the employer was cheating on taxes. Notice that the excuse to steal was based on the employee's perception of the boss's tax compliance. It had no bearing on what the boss actually did. It was all based on perception.

Get with your tax consultant, make the best decisions for your business, sleep well at night and prosper!

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