The Retailer And The Taxman

While it isn't a popular topic for many people, preparing your business' taxes and making sure Uncle Sam gets the right amount is a necessary concern. Learn what you should and shouldn't be focusing on when it comes to taxes in the first part of this 2-part series.

By
Bill McCurry

"If it regards the Internal Revenue Service and if it makes you smile, it must be illegal." We refer to this as Mitchell's Rule #1, named after David J. Mitchell, CPA, who was the first associate of McCurry Associates. This rule has been accurate 99 percent of the time. In short, Uncle Sam feels largely responsible for your success and deserves to share in it. Most small business people don't mind paying taxes; it is the amount of taxes that is the objection. For that reason, we have some companies engaging in aggressive tax planning.

You may not like this message, but it's simple: Obsessing on taxes will cause you to make the wrong business decisions and miss glorious opportunities. Here's how it happens: You say to an otherwise intelligent garden center owner, "Hey, if you invest $50,000 in this, you can generate $200,000 in gross margin over the next three years. That will boost your net profit by $150,000. You'll pay around $60,000 in state and federal income taxes and net at least $90,000." Before long, the entire conversation shifts to how to reduce the $60,000 tax burden rather than leverage the $200,000 up to $300,000 or more.

Yes, it is the time of year when we're all aware the tax man is coming, so let's determine the right mix of tax paying versus intelligent tax planning.

Learning From Abe

To put it in perspective, let's start with a lesson from Abraham Lincoln. When he was an Illinois attorney, Abe represented a poor widow who was suing the president of the local bank and asking for $5 in damages. The bank president, a pillar of his community, is alleged to have visited Lincoln's office and, in the presence of Lincoln's partner, offered Abe a bribe to throw the case. Lincoln is reported to have said, "No, the lady deserves her day in court."

The banker responded that it would be humiliating if he lost to this widow, so he raised his bribe to $25. Lincoln refused. "$50," said the banker. Abe refused again. The banker stood up, started reaching for his wallet and said, "Mr. Lincoln, you drive a hard bargain. I'll give you $100 cash right now." Abe jumped up, physically grabbed the banker and threw him out the door, pitching him into the mud outside. Lincoln's partner was astonished. "Abe, he tried to bribe you three times and you didn't mind. Then the forth time you just seem to blow up," he said. Abe responded, "He was getting too close to my price."

What's our lesson from Honest Abe's example? Determine your price now, today. How much do you need to cheat/steal before you'll be tempted? Tax evasion is a crime. Will you risk your reputation with family, friends and colleagues for $100? $1,000? Before you're tempted to claim your dog as a dependent, think of the ramifications.

Of Course It's Legal

It is not uncommon to hear, "Of course it's legal; I have done it for years without any repercussions." It's like the employee who is stealing from his or her employer. Just because the employee hasn't been caught yet doesn't mean the boss is supporting the theft. Uncle Sam thinks the same way.

When we questioned a client's approach to a situation, the client boasted, "We've been audited, and they didn't say a thing." The audit was actually limited to his personal deductions for charitable contributions and had nothing to do with the issue we were raising. He went to his CPA so we would get off his back, and his report to us was this: "The CPA's face went white when we told him what we were doing. Someday we'll have to change that." The situation we are worried about is still an "exposure" for our client. Is it really worth the risk? Everyone has to make his or her own judgments.

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Loopholes

There is a balance here. In 1934, Judge Learned Hand wrote one of the most often quoted decisions in U.S. history: "Anyone may arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the Treasury; there is not even a patriotic duty to increase one's taxes." (Helvering v. Gregory)

This decision allows businesses to conduct affairs in the most advantageous ways consistent with tax laws. This also gives rise to "loopholes," tax incentives to encourage certain behaviors desired by our legislative leaders. (Think low-income housing, solar credits, accelerated depreciation or the most widely used tax loophole, the home mortgage deduction.)

Just because Congress or your state legislature writes a loophole to encourage you to take a certain action, doesn't mean it's a good business decision. Congress especially has proven to be an untrustworthy partner for long-term planning. Currently we "assume" long-term capital gains and dividends will be taxed at a lower rate — but who knows what the future will hold. The inconsistencies of our nation's tax policies make it difficult to plan. They also make it unwise to set in concrete any plans you do make because they'll have to be changed when the political winds rewrite the relevant section of the tax code.

Check With Your Counsel

The following are areas you may want to talk about with your competent tax counsel. In a column like this, I cannot begin to give you tax advice. What I can do is point out areas that may impact you so you can probe them with a good local tax advisor. Depending on the dollars involved, superb tax counsel is usually a great investment. If your tax advisor is cheap and always available, regardless when you call, you may be talking to the wrong person. Don't be intimidated by a high hourly rate. Make sure your tax counsel knows enough about your situation so they can advise you accurately. That's going to require you to invest a certain amount of time educating them. Do it!

Charitable deductions. These warrant a couple of mentions. Many small corporations are limited in the total amount of charitable deductions they can use due to a cap based on a percentage of their profits. There is no cap on reasonable marketing expenses. So if you're going to donate floral centerpieces for the church dinner, ask your accountant about writing it off as a marketing expense rather than a donation.

Too often well-meaning but misinformed speakers on marketing have said you can deduct, at their list price, items you donate to charity. In some situations, you can deduct appreciated property that is donated under certain circumstances. Rarely will traditional garden center inventory come under those classifications. When in doubt, check with your accountant.

Also, refer to Mitchell's Rule #1 at the start of this column. Your accountant will probably tell you that you are eligible to deduct your actual out-of-pocket costs that you haven't already deducted. If you donate hard goods, then you can deduct the cost ➧

you paid your supplier. If you donate products you have grown, you can deduct your costs that are in inventory. If you have already deducted the labor to grow the product, you can't deduct the labor again. This is true whether you write it off as a marketing expense or as a donation.

Sales tax. There are special stipulations you must keep in mind. You're required to act as bookkeeper for your state taxing authority. It is time consuming, full of risk and a huge frustration for retailers, many of whom have told us they've been audited by their state sales tax agencies and hit with significant back taxes, penalties and interest. The biggest bone of contention seems to be when they made sales "tax exempt for resale" and the state didn't agree with them. In many cases, the retailer's paperwork didn't meet current state regulations. The retailer hadn't changed the way they accounted for resale transactions, they had just never been audited. (Remember "deducting your dog" that we talked about earlier?)

As states become more desperate for revenue, they go after their locally owned merchants who lack sophistication and can be easy sources of money. Many states base the budget of their auditing departments solely on the amount of penalties and interest they collect. This means you have what amounts to commissioned bounty hunters looking over your shoulder, just waiting to catch you doing something wrong — and the more expensive the penalty, the better.

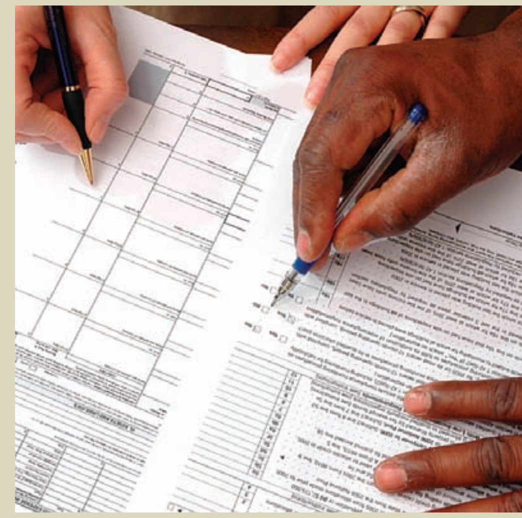
There are two solutions for this:

• Ask your accountant if he or she has current sales tax expertise. Many accountants don't stay updated in this field. Also have competent advisors review your sales tax procedures.

• Attend as many industry events as you can. Ask garden centers from your state what they have heard about sales tax audits. Don't argue with them: Listen! Learn!

Bad debts. If there is any good news about bad debts, it may be the loss is tax deductible. Also, check out how bad debts impact your sales tax liability. In most states, if you are not paid for the merchandise, you don't have to pay the tax. From a practical sense, you've already paid the tax, so it goes as a credit on your next tax payment. For tax purposes, bad debts include bad checks and rejected credit card transactions.

Use taxes. If you haven't figured it out yet, life isn't fair. Your customers may think that Internet purchases are "sales-tax free." If your state has a sales tax, then it also has a use tax that requires out-of-state purchases to be reported and use tax paid on those out-of-state purchases. The average consumer is ignorant of this requirement or chooses to ignore it, with virtually no risk. Many states are now auditing businesses to be sure the business is complying with this requirement. Make sure anything you buy out of state is properly recorded and you are paying applicable use tax, or be prepared for penalties and interest.



Make sure your tax counsel knows enough about your situation so they can advise you accurately. That's going to require you to invest a certain amount of time educating them.

States Expect Payment

Here's another war story we picked up recently at the CENTS show. The garden center planted new material in front of the store and wrote it off out of inventory. The sales tax auditor wanted to see where the garden center paid the use tax. Yes, you know what happened.

The garden center had never paid use tax on materials it used. That was the wrong answer, and the state "compromised" by assigning an average value per month over the last 36 months. This garden center thought they got off lucky paying only $4,500. More than half the payment was penalties and interest.

Most states feel they are due sales or use tax on every physical product that gets used in their state, so if you're using it in your business, the state is most likely expecting you to pay them. You know the saying: "Pay me now or pay me later (with penalties and interest)."

Next month, we'll look at some other tax pitfalls to avoid before they trip you up and send you spiraling into chaos.

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