

From this week's Focus

The tax man cometh: dealing with an inescapable small-business reality

By: Kevin McKeough October 17, 2011



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Photo by: Stephen J. Serio

Death and taxes may be the only certain things in life, but businesses at least can take steps to reduce their tax liability. Accountants can help guide a business to make tax-reducing decisions as well as prepare the relevant financial reports.

"Tax is not a field where it's a question of being smart or stupid. It's a matter of knowing what the rules are," says Geoff Harlow, tax partner at Kessler Orlean Silver & Co., a Deerfield accounting firm that specializes in small business.

LEGAL STRUCTURE: The first step is to make certain your business has the legal structure that best suits its needs, whether it's a limited liability corporation or an S or a C corporation. Mr. Harlow says that businesses often incorporate before consulting an accountant and that it's not unusual for them to choose a structure that causes problems. For example, people may include real estate as part of a C corporation, which can lead to gains on a property's sale being taxed both as corporate and individual income. And an S corporation only can have certain

kinds of shareholders, which can come as a surprise to owners who were expecting capital from an ineligible investor.

Six years after Bernie Garvey and his siblings bought Garvey's Office Products Inc. from their father in 1993, the Niles business-to-business supplier had grown to the point that they decided to change it from a C to an S corp. The switch allowed the Garveys to avoid the double whammy of paying corporate taxes before paying themselves a dividend that would be taxed as personal income.

"You either need to be very comfortable with the routine you've set up in your office and make sure it's being maintained, or outsource it through an ADP or a Paychex (payroll processing companies) to make sure the filings are made and the quarterlies are done," says Mary Lou Pier, president of Pier & Associates Ltd., a Loop accounting firm.

CAPITAL PURCHASES AND DEPRECIATION: Since the current generation of owners took

over, Garvey's Office Products has changed offices twice, buying larger buildings each time. In both instances, the Garveys utilized a provision in the tax code that allowed them to avoid capital gains on the properties by reinvesting the proceeds of the sale of the old building into the purchase of the new one. "If we were to pay taxes on it, we wouldn't have been able to afford the new facility, or would have bought something lesser," says Bernie Garvey, the company's president.

While property may appreciate in value (the past few years notwithstanding), other capital expenditures typically depreciate. That depreciation is deductible, but accounting for it can be tricky, as Scott Bartmess discovered.

"We had overdrawn by high five figures. Everyone had to pay the money back into the business to make up the shortfall," says Mr. Bartmess, vice-president of Esscoe, which he says is profitable and on track to generate more than \$5 million in revenue this year. If the glitch hadn't been corrected, it could have been a red flag for the IRS and Esscoe's bank and surety company.

"Unless you're booking your depreciation in quarters, you don't have an accurate record of where your depreciation is going to end up at the end of the year," Mr. Bartmess says. That complexity is one of the reasons Esscoe has switched from buying and depreciating its vehicles to leasing them and directly writing off the costs.

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— Geoff Harlow, Kessler Orlean Silver & Co.

After starting Esscoe LLC, which provides security and fire alarm systems to businesses, schools and the government, Mr. Bartmess and his colleagues didn't keep track of their accumulated depreciation, which wound up totaling in the high five figures by the end of the Mundelein company's first year.

As a result, Mr. Bartmess and Esscoe's other two owners overestimated how much money they could take out of the company. When their accountant included the depreciation in Esscoe's balance sheet while computing taxes the following year, the company was technically in the red.

"You have to understand what's better for your business. Is it better to write off the whole expense, or is it better to depreciate over time?" Mr. Bartmess says.

TIMING: As that question illustrates, in taxes, as in comedy, timing is crucial. How well a business is doing in any given year may influence tax-related decisions.

"Am I having a bad year in the business? Would I be better off accelerating some income into this bad year to take advantage of the lower tax bracket I'm in because of this bad year?" Mr. Harlow reflects.