PLAYING TAX DEFENSE + OFFENSE WHEN STARTING A NEW BUSINESS

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INTRODUCTION

Today many entrepreneurs want to try their hand at developing a new product or service that will solve a problem, fix a pain point or change the world. It is instinctive to focus one's attention on the technology and the product market fit. Attorneys, however will frequently advise the entrepreneur to set up a legal entity right away in order to minimize legal risks, and to establish agreements among the founding team to reduce friction and misunderstandings that can develop as the business evolves. Even if a product has not yet been developed or revenue has not yet been generated, once a legal entity is established or once an agreement is reached by individuals to work together to share profits and losses, tax matters must be addressed as inevitably tax consequences result. One of the key indications that an entrepreneur is able to transition from the creation of a product to the creation of a successful business is his/her ability to manage corporate responsibilities.

PLAYING DEFENSE: MINIMIZE UNNECESSARY RISKS AND COSTS

Some entrepreneurs believe that because their business is generating losses, it is not important for them to focus on their tax responsibilities. Unfortunately a number of pitfalls exist which could create risks and generate tax liabilities in spite of such losses. Some of the key issues are detailed below:

1. Don't create unlimited future tax risks
   Generally speaking when a tax return is filed, a tax authority has a certain period of time, called "the statute of limitation" in which to audit the tax return for a given period. This statute of limitation is usually three years and begins to run usually on the later of the due date of the return or the date of the actual filing of the return. Even if you have losses, you still need to file a tax return because if no return is filed, the statute of limitation does not begin to run. This means that the IRS could issue an assessment 10, 20, 30 years later and it could be impossible for you to produce the necessary records, at that time, as evidence to support your deductions. This issue does not only apply to income tax but also applies to other taxes such as state taxes i.e. sales tax.

2. Don't pay other people's taxes
   One of the key characteristics of a business is its "footprint". The entrepreneur must always be aware of his or her business's footprint across different taxing jurisdictions. In cases such as sales tax or federal withholding tax, the tax itself is not imposed on the company but instead is imposed on the customer or a foreign party. In these cases, the company merely has the duty to collect the tax and remit it to the state. If the company does not realize that it has an obligation to collect sales tax or withholding tax, it may incur a very large liability if the tax authority establishes that this duty to collect exists. At that point, the company is obligated to pay the tax itself out of its own coffers because in most cases, the customers are long gone. In addition, both the company and the individuals who are in charge may be subject to penalties called "responsible person assessments and trust fund penalties". Paying taxes imposed on customers and hefty penalties are a heavy burden for any young company to bear.

3. Don't pay tax twice on the same income
   The entrepreneur must also be aware of the company's tax footprint across different countries. It is possible for a government to have tax authority over a company based on where the company is incorporated, resident or doing business and/or also absent these characteristics, a country may have jurisdiction over a company's transaction. For example, a company may be incorporated in the US and resident in the US but may be receiving revenue from a client in another country for licensing transactions. This country may impose a withholding tax on the customer's remittance so that the company receives its selling price, say, 100 less a 30% withholding tax on gross revenue for a remittance of only 70. Normally, one would expect to obtain a US tax credit for foreign taxes paid, but this may not always be the case. Contracts and agreements covering cross border transactions must be carefully structured to avoid double taxation, otherwise you could easily pay an overall tax rate much higher than the U.S. 35% rate. Paying tax twice on the same income without the benefit of tax credits will quickly erode the profits of any company.

4. Don't fall into tax traps
   An entrepreneur who is "bootstrapping" – funding the startup with sweat equity and his or her own money – generally tries to save as much money as possible and keep the lid on overhead expenses. Many will hire independent contractors in order to avoid setting up a payroll system and paying employment taxes. There are well-documented rules that provide guidance in distinguishing when a person is an independent contractor or really an employee. These rules are discussed in IRS publication 15A. Both the federal and state governments have targeted this issue as a focus item, and it is not unusual for a tax auditor to issue a tax notice or assessment to a very early startup when it falls into this tax trap.

   Another trap for the unwary entrepreneur is estimated taxes of federal and state income tax. This problem can arise if the entrepreneur has the good fortune of going from losses in one year to scalable revenue and profits in the next. The company may not have been preparing an estimate of its taxable income and may therefore be subject to interest and penalties for failure to make quarterly estimated taxes.

   Time is money and thus the amount of time and money that the entrepreneur has to spend in dealing with tax auditors and assessment can certainly derail a company from pursing its business objectives.

5. Don't raise red flags
   In an effort to save money, entrepreneurs may try to take advantage of tax benefits that have been used and abused over the years and which now have a higher standard of documentation. These deductions include a home used as an office, meals and entertainment and items which can be used as both business and personal expenses.

PLAYING OFFENSE: TAKE ADVANTAGE OF TAX INCENTIVES

The government encourages business activity in certain sectors by providing tax incentives. Research and development as well as software development and small business activities are areas which are encouraged. One of the roles of the CPA is to help the entrepreneur take advantage of all the benefits to which he or she is entitled. Tax planning can be grouped in these five categories, in ascending order of how important and beneficial they are – similar to a one- to five-star hotel ranking:

1. Do pay later
   Most tax planning activities involve deferring income and accelerating deductions. If tax is paid later, then the business has use of the cash for a longer period of time and can grow its business.

   When interest rates are high, the present value of the cash flow that results from paying tax later can be very lucrative. One of the tax incentives for software development is the ability to deduct software development costs as current expense even if the product developed may have a useful life that can extend over a number of years. In addition, when a company is conducting research and development, it can obtain a deduction for these activities well before it is engaged in carrying on a trade or business. Normally, excess startup costs must be amortized over 60 months, but costs associated with software development, which qualifies as research and development, can be written off currently.

2. Do pay a lower rate of tax
   At times, opportunities exist for a business or for an entrepreneur to pay a tax rate that is lower than the standard rate. There are production incentives that may be available for exports of software products which reduce the effective rate below 35%. In addition, from the founder's perspective, an entrepreneur who receives founders' shares of his or her new company, may ultimately pay tax on the sale of the shares at the 15% capital gains rate in contrast with the ordinary income tax rate of 35% which is the rate of tax on compensation or stock options.

3. Do arbitrage the rates
   Arbitraging opportunities do not come about every day. Luckily, a business which develops software is able to get ordinary tax deductions at 35% for software development expenses when characterized as research and development. When the intellectual property (copyright rights) is sold, however, then the gain on the sale, under certain circumstances, can be taxed only at the 15% capital gains rate.

4. Do pay less by using credits
   Since 1981, the increase in qualified research and development activities can be eligible for the research and development credit. If this credit cannot be used immediately in the early tax returns because losses exist, it can be carried forward for 20 years. Another example is the exemption that is provided for certain qualifying sales of small business stock.

5. Do get money back

Every now and then, the federal or a state government will be so motivated to generate jobs or encourage certain activities in its jurisdiction that it will offer refundable tax credits and will actually pay the company for performing certain activities such as increasing employment.

CONCLUSION

What is an entrepreneur to do with so many urgent matters to address and not enough time in the day or money to staff up to handle all the demands? Build a team! Yes, the entrepreneur must surround him or herself with a team of experts who can bring their skills to bear and insure that the entrepreneur and the business avoid costly mistakes of either commission or omission. The team should include a CPA whose expertise is both broad and deep enough to meet the needs of the growing business.

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The firm's subsidiary, Tailored Technologies, LLC, provides information technology consulting services. In addition, its membership in Morison International, a leading international association for independent business advisers, financial consulting and accounting firms, facilitates service delivery to clients throughout the United States and around the world. Marks Paneth & Shron LLP, whose origins date back to 1907, is the 32nd largest accounting firm in the nation and the 13th largest in the New York area. In addition, readers of the *New York Law Journal* rank MP&S as one of the area's top forensic accounting firms.

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