It is never too early for effective tax planning

Final quarter is the right time to prepare for year’s end

For most individuals and many businesses, the impending end of the calendar year should bring thoughts of tax planning along with those of the approach of cold weather and the holiday season.

Major tax planning is best done now. However, if you’re making a late start, there are a number of items which should be kept in mind by the businessman as the end of the year comes near. What follows, then, is a partial summary of these considerations:

• **Deductions.** From an accounting and tax viewpoint, whether a corporation is a cash basis taxpayer or an accrual basis taxpayer is an important distinction to note. In order for a cash basis taxpayer to justify a deduction, the payment must be made in the year for which the deduction is claimed. For an accrual basis taxpayer, an obligation must be expressly assumed or fixed on or before the end of the taxable year.

Thus, if a cash basis corporation’s calendar ends its taxable year on December 31, all payments for which a deduction is claimed must be made by that final day of the year. However, an important exception to this rule concerns qualified pension and profit-sharing plans, which are discussed later in this article.

In an accrual basis situation, it is quite simple (yet very important) to reflect the accrual in corporate minutes of a meeting of the Board of Directors. These minutes should accurately reflect corporate action taken and simplify justification of the accrual for tax purposes. Failure to obey these simple rules can result in unnecessary potential tax liability.

• **Prepaid expenses.** Particular care must be taken in regard to prepaid expenses. Any payment or accrual of a prepaid expense requires consultation with a professional tax advisor. Necessary to the consideration of the payment are the discussion of the nature of the expense, the period for which prepayment is being made and the applicable Internal Revenue Service guidelines.

In one circumstance, a cash basis taxpayer mischaracterized an intended bonus as a prepaid salary, and the IRS objected to taking a current deduction for prepaid salary. The deduction was disallowed, and the taxpayer entered into an agreement with the IRS under which the corporate tax return was amended to reflect the deduction as extra income, even though the money had already been paid to the employees. The corporation was permitted to deduct the payment in the subsequent year.

There is a possibility of a taxpayer losing a deduction in the claimed year and still not being allowed to take it in the subsequent year. If the taxpayer is on a cash basis, he might not be able to show that a prepaid item is paid in the actual calendar year (the next one) for which the deduction is claimed. These are possibilities that mandate getting proper advice from qualified tax advisors.

**Vulnerabilities**

There are several areas where taxpayers are particularly vulnerable to challenges under current roles on the deductibility of items:

• **Compensation.** Be aware of the rules applicable to “unreasonable compensation” to avoid loss or diminution of deductions. Even something as simple as the label you put on a form of compensation can impact its deductibility.
Bonuses. The evaluation of unreasonable compensation takes into account the payment of bonuses. Accordingly, the amount of bonus monies paid to officers who are shareholders cannot be ignored. If there is a potential problem in this area, a good tax plan includes consultation with a tax advisor. This professional, again, can determine what evidence of reasonability can be accumulated and by what process the evidence should be compiled. Cash basis taxpayers must pay bonuses on or before the end of the tax year; accrual basis taxpayers must accrue the obligation and pay the actual bonus declared to a stockholding employee who holds over 50% of the company’s stock within two-and-a-half months of the end of the fiscal year.

Dividends. Many small or closely-held corporations do not declare dividends, since dividend payments are not deductible to the corporation and compensation is. The IRS pays particular attention to whether compensation payments to officer-shareholders can be recharacterized as dividends to shareholders. To avoid this, some closely-held corporations declare small dividends—purposely—to avoid attack by the IRS on a larger scale.

Pension and Profit-Sharing Plans. Under tax laws, there are limits on contributions made to and benefits payable from these plans. Careful consideration of the calculation of the permitted contribution is required. Although both cash and accrual basis taxpayers are permitted to deliver the contribution to the trustee within two-and-a-half months following the close of the tax year (or the time for filing the return), it is advisable to not wait until the last minute, when you run the risk of losing the deduction.

Editor's note: Mac Stokes, a partner in the firm of Stokes & Shapiro, not only serves as AWCI general counsel, he holds the same position for other construction associations. The author of numerous books and magazine articles, Stokes also is a regular contributor to his firm's monthly newsletter, which deals with numerous topics of current legal interest. For information about the newsletter, call (404) 658-9050 (Atlanta) or (202) 857-0968 (Washington, D.C.).

Conclusions

All in all, recognition of income is a very important element in effective tax planning. Generally, a cash basis taxpayer has the ability to shift income from one year to another with greater ease than the accrual basis taxpayer. For example, if a cash basis taxpayer can bill or collect for sold items in advance or request payment on delivery instead of through normal billing or invoicing schedules, he can accelerate income. On the other hand, subject to certain rules dealing with the concept of “constructive receipt”, a cash basis taxpayer may be able to invoice after delivery or the beginning of a new tax year, which has the net effect of deferring the income to the subsequent year.

The rules of constructive receipt are applied to situations where a taxpayer has an absolute right to receive payment, even though payment is not requested. In such cases, the income is considered taxable regardless of whether the money was or was not received.

The obvious conclusion here is that tax planning is a complicated process that requires time for consultation with professionals in the area. Proper tax planning—now—can lessen your tax burden. The beginning of the next calendar year (or fiscal year) may not only be too late to plan for the best tax treatment, it may also foreclose opportunities that are now open to you.

There is no better time for calendar-year taxpayers to plan their tax strategies than right now.

Compliance with wage and hour laws

By McNeil Stokes, General Council

In a recent decision by the Department of Labor’s Wage Appeals Board, a federal contractor’s debarment was upheld, despite a showing that back pay had been distributed and past infractions had not been repeated. The contractor involved had been performing federal government work for at least ten years and had had more than 100 government contracts since 1974. In 1973 and 1974, the contractor was found in violation of the Davis-Bacon Act and the Contract Work Hours and Safety Standards Act at Ft. MacPherson, Georgia, by failing to pay prevailing wage rates and overtime, and by classifying employees at lower performance levels than their actual work indicated. The contractor was assessed $67,000 in back wages to its own employees, $13,000 in back wages to employees of a subcontractor, and $12,600 in liquidated damages for overtime violations. Subsequent to a settlement agreement whereby the contractor agreed to pay $80,000 in back wages and subsequent to his actual payment of that amount to involved employees, the Wage and Hour Division brought debarment proceedings against the contractor.

In upholding the contractor’s subsequent debarment, the Wage Appeals Board stated that the settlement of back wages does not necessarily dispose of the government’s claim; the only pertinent test for debarment is whether or not a contractor’s wage and hour violations were willful and constituted a disregard of a contractor’s obligations to its employees. The Board was not persuaded by the contractor’s explanation that the errors in payroll records were no willful or deliberate, but rather were inadvertent and to be expected because the contractor had several simultaneous federal projects in progress at Ft. MacPherson. Furthermore, the Board stated that it expects a contractor with considerable federal contracting experience to keep particularly accurate records and be able to avoid the pitfalls of labor standard violations due to their familiarity with those standards. Ace Contracting Company, Inc., WAB Case No. 7623 (May 30, 1980).

The implications of this decision for those of you performing regular federal government work could be substantial, as it appears that you could be held to a higher standard of accuracy in your payroll data and documentation in a Wage and Hour review. If you are a general contractor, you also have responsibility for the actions of your subcontractors. In order to avoid the triggering of a Wage and Hour investigation, we recommend that you carefully review your own certified payrolls, as well as your subcontractors’, for obvious errors or suspect information.