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Tax Optimization at Different Stages of the Business Lifecycle

As a business owner, most of your time and effort go into tasks such as managing day-to-day operations, overseeing a team, monitoring sales, and communicating with clients and shareholders. Amidst these responsibilities, it can be easy to put financial planning tasks like tax planning and optimization on the back burner. Tax optimization is essential for the success of a business, regardless of its stage, as it can lower tax liabilities. The tax optimization and planning process must evolve alongside your business, and strategies can vary depending on the business stage. In this article, we outline each stage of the business lifecycle and share optimization strategies for corporate taxes.

Seed/Startup

In the beginning stages of a business, it can be useful for owners to work with an advisor to establish a tax plan that will help the business be sustainable and grow over time. As a startup entrepreneur, you want to know how to take advantage of deductions for startup costs and other credits that exist for small businesses, while also properly allocating resources and avoiding penalties for tax non-compliance. Here are some strategies to consider:

01 CHOOSE THE RIGHT BUSINESS STRUCTURE

When starting a business, owners can decide what type of structure to have for the company. A business structure is the legal framework of a company that defines how it is organized and operates. The most common structures are sole proprietorship, partnership, corporation, S corporation, and limited liability company (LLC). Depending on which entity you choose, you could potentially save anywhere from 10% to 40% on your taxes each year.[1] However, business owners should know that these structures come with different personal liabilities.

Sole proprietorships: Sole proprietorships are easy to form and low risk. You have full control of your business and are considered one entity. Your business assets and liabilities are not separate from your personal assets and liabilities. However, you can still be personally liable for the debts and obligations of the business. This structure is more suitable for small startups.

Partnerships: Partnerships are a structure where two or more people go into business together. In a partnership, each partner is responsible for reporting their own profits and losses from the business on their personal tax returns. Additionally, you and the other party own the income and losses of the business, though liabilities between the parties vary depending on whether it's a limited partnership or a limited liability partnership. This can be an option for businesses with multiple owners, professional groups (like attorneys or CPAs), and groups who want to test their business idea.[2]

LLC: Selecting an LLC as your business structure allows you to leverage the benefits of both the corporation and partnership business structures. An LLC typically protects you from being personally liable in case your business is sued or goes into bankruptcy. Your profits and losses can get passed through to your personal income without you having the burden of paying corporate taxes. However, members of an LLC are considered self-employed and therefore are required to pay self-employment tax contributions toward Medicare and Social Security.

C Corp: A C corp, or corporation, is a legal entity that's completely separated from its owners. Similar to an LLC, one of the benefits of a corporation is that it offers strong protection from personal liability. What makes corporations different is that they are more expensive to form and they require more extensive record keeping, operational processes, and reporting, making them more of a risk to the owners. Corporations also pay income tax on their profits and in some instances, are taxed twice when corporate earnings and dividends are paid to shareholders, as that profit is taxed as capital gains on the shareholder's personal tax returns.

S Corp: An S corporation is a corporation that elects to pass corporate profits, losses, deductions, and credits through to its shareholders for federal tax purposes. Categorizing your business as an S corporation may look different tax-wise depending on what state you live in. Some states don't recognize the S corp election on taxes and treat S Corp businesses as C corps, while others tax S corps on profits above a specified limit. You are also required to file an S corporation with the IRS.

For more information on the tax responsibilities and advantages of each of these structures, visit https://www.irs.gov/pub/irs-news/fs-08-22.pdf.

02 DEDUCTING STARTUP COSTS

Starting a new business gives you the ability to deduct certain expenses that are needed to get a business off the ground. Expenses such as advertisements, fees for accountants, attorneys, and consultants, and purchases for computers and desks can all be deducted. The limit for these deductions is $5,000 each year and they can be amortized over a period of 15 years as long as they are incurred during the planning and development phase of your business.[3] If the business operates from your home, you can also write off home expenses like mortgage interest, rent, insurance, and utilities.

03 IMPLEMENTING A RETIREMENT PLAN

Selecting a retirement plan for your business is another tax advantage that can also help attract talent to your business. Startups can potentially qualify for tax credits when setting up plans for employees like a SEP IRA. Your 401(k) contributions to your employees' retirement accounts are also tax deductible.

Growth Stage

Once your business has transitioned from a developing to a growing one, it's crucial to revisit your tax strategy early on. Reviewing your tax strategy at the onset of growth is critical, as expansion brings new challenges. Having a plan for this stage can help you avoid mistakes with long-term consequences. Growing businesses should consider the following:

01 DISCOVER TAX CREDITS AND INCENTIVES

Small-to-midsize businesses that develop new or improved products, processes, software, techniques, formulas, or inventions can be eligible for research and development (R&D) tax credits. These credits allow businesses to deduct current expenditures or claim a credit for increasing research expenditures. Qualifying research activities can include anything from developing a formula or prototype of a product to hiring scientists, designers, and engineers who are involved in helping actualize or enhance products.[4]

Additionally, businesses with under five million in gross receipts in the current year and no more than 5 years of generating gross receipts can also claim an R&D tax credit of up to $25,000 per year against their payroll taxes. Generally, 6% to 8% of a company's annual qualifying R&D expenses can be applied for the credit. To apply, you must fill out IRS Form 6765, Credit for Increasing Research Activities. Due to the complexities of the qualifications of this credit, please speak with your advisor for additional guidance.

There are also tax credits for growing businesses that hire and employ workers from certain targeted groups that face significant barriers to gaining employment. This credit is called the Work Opportunity Tax Credit. Employees and candidates who are qualified IV-A recipients, veterans, ex-felons, designated community residents, vocational rehabilitation referrals, summer youth employees, Supplemental Nutrition Assistance Program (SNAP or "food stamp") recipients, Supplemental Security Income (SSI) recipients, Long-term Family Assistance (Long-term TANF) recipients, and Qualified Long-term Unemployment recipients are all a part of the targeted groups. Any business of any size is eligible to claim this credit though, taxable employers can claim the WOTC against income taxes while eligible tax-exempt employers can claim the WOTC only against payroll taxes and only for wages paid to members of the Qualified Veteran targeted group.[5]

02 EXPLORE AREAS WHERE YOUR BUSINESS CAN EXPAND

As your business grows, it may outgrow its initial headquarters. Entrepreneurs may decide to move their operations to a new facility in another municipality or state. If you are considering moving to a nearby town, research the municipality's income, sales, and property taxes. You can also find out if the area provides tax credits that offset your payroll or infrastructure investments.

03 CREATE A SUCCESSION PLAN

Though you may have just started your business, it is not too early to think about creating a succession plan. A succession plan establishes who will be in charge of your business if you or your business partner exit, become incapacitated, or pass away. A well-thought-out plan can help reduce stakeholder uncertainty by assuring the business runs smoothly and maintains its value following an ownership change.

A succession plan can include guidelines specific to your business and its market position. However, there are a few standard components, regardless of your business classification:

- Mapping out the roles in your company that are most vulnerable in the event of a vacancy is critical for your business continuity.
- Evaluating how your or your partner's departure could affect internal parties like direct reports and beyond, and external parties like customers, stakeholders, and suppliers.
- Identifying potential successors who have the skills, knowledge, and ability to manage and lead successfully.
- Communicating your plans to the employees whom you have chosen as successors so they are aware and prepared for the transition.
- Offering career development programs that empower employees to gain more knowledge and experience.
- Creating a timeline for a trial run of your plan.

After creating your plan, it is important to regularly update it to account for organizational changes, market performance, evolving competitive threats, employee performance, and business strategy. Please work with your business leaders and financial advisor to make sure this information is relevant and up to date.

Maturity Stage

Once your business has transitioned from a developing to a growing one, it's crucial to revisit your tax strategy early on. Reviewing your tax strategy at the onset of growth is critical, as expansion brings new challenges. Having a plan for this stage can help you avoid mistakes with long-term consequences. Growing businesses should consider the following:

01 RETHINK PROCUREMENT AND DEPRECIATION

One of the largest expenses for a business is the purchase of equipment and supplies. While purchases like a new printer or a service vehicle are typically necessary for the business to run efficiently and generate revenue, they can increase your business's taxable income. If possible, consider making those types of purchases before the end of the year by leveraging Section 179 to help lower your tax burden. Section 179 allows businesses to immediately write off qualifying equipment or software for that tax year (up to $1,220,000 for the 2024 tax year).[6]

Other tax strategies business owners can use are the straight-line depreciation method and the accelerated depreciation method. Depreciation, as defined by the IRS, is an annual income tax deduction that allows you to recover the cost or other basis of certain property over the time you use the property. When you use the straight-line method, you spread the depreciation evenly across the asset's useful life. So, for example, when the $48,334 vehicle that you purchased for your business reaches 12 years old, the average lifespan for a passenger car, you depreciate it by an average of $4,000 each year. Alternatively, through the accelerated depreciation method (Modified Accelerated Cost Recovery System), you could take larger deductions earlier in the vehicle's life to reduce taxable income as early as possible.

02 DEFER TAXABLE INCOME

If your business performed exceptionally well this year, and your business is not a C corporation, you may want to consider deferring income into the next tax year. C corporations have the benefit of having a flat federal corporate tax rate of 21% but are subject to "double taxation" or taxation at two different times.[7] Other business structures potentially can also receive a lower rate if they delay until the following tax year.

One approach business owners can take is to adopt the cash method of accounting. Under this method, you can report income in the tax year that you receive it and deduct the expenses in the tax year in which you pay it, though if you don't already use this accounting method, you must fill out a 3115 Application for Change in Accounting Method.[8] When using the cash method of accounting, you can also decide to delay year-end billing to your clients so their payments are not received until the next tax year.

03 TAKE ADVANTAGE OF CHARITABLE GIVING

Charitable giving is a great option for businesses that not only want to lower their tax burden but also make a lasting impact on the communities that they serve. Business owners should seek tax-exempt organizations initiatives that align with their personal values and business mission. These donations can be through cash or sponsorships. However, it is important to note that there are rules regarding how to take a deduction if you have a certain business structure. Businesses that are sole proprietorships, S corps, and partnerships receive deductions through the personal returns of their owners, with the latter structure requiring partners to take a percentage share of the deduction on each return. These donations also must be itemized to receive the benefit.

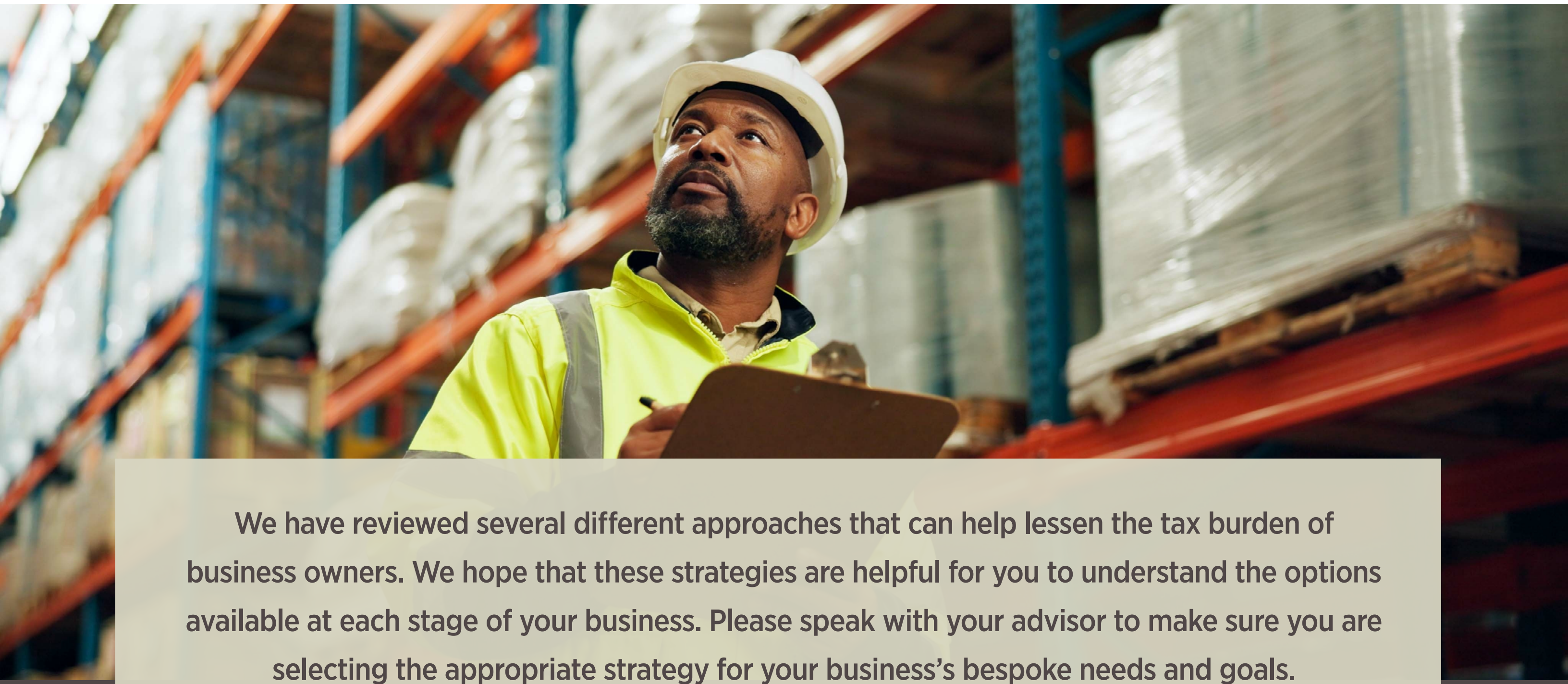
Exit Stage

At a certain point after owning your business, you will likely decide to exit. Whether it's because of personal reasons like retirement, burnout, an urge for a lifestyle change, or financial reasons from increasing competition, poor performance, or stagnation, you want to establish a well-thought-out plan on how you will exit.

As mentioned earlier, a business should have a succession plan early on in its lifecycle. That plan should be one of the first things that is reviewed when considering a sale. The second thing that should be analyzed prior to a sale is whether you would like the sale to be an asset sale or a stock sale. An asset sale involves selling the assets of the company, while a stock sale is the sale of all of the owners' shares to an acquirer. In an asset sale, the seller keeps the legal entity while the buyer purchases the individual assets such as equipment, fixtures, inventory, and licenses to name a few. In asset sales, the seller will typically retain the long-term debt obligations and will be taxed higher because intangible assets can be subject to higher ordinary income tax rates.[9]

In contrast, with a stock sale, the buyer obtains ownership in the seller's legal entity. Buyers will acquire almost the same assets and liabilities they would through an asset sale, but a caveat to that is if they do not want certain assets, those can be distributed or paid off by the seller prior to the sale. For sellers, this is favorable for two reasons; the first is that the proceeds of this type of sale are taxed at a lower capital gains rate (for C corporations sellers are only taxed once on the gain of the sale), and the second is that they are sometimes less responsible for future liabilities such as employee lawsuits, pensions, and contract claims.

Lastly, if you want to extend your charitable giving efforts, you can consider contributing to a donor-advised fund (DAF) during the selling process. Business owners who contribute to a DAF can move company stock into the fund to receive a charitable deduction on their tax returns. Then, when the business is sold, the shares in the fund will become converted to cash to donate to a variety of charities of your choice.



We have reviewed several different approaches that can help lessen the tax burden of business owners. We hope that these strategies are helpful for you to understand the options available at each stage of your business. Please speak with your advisor to make sure you are selecting the appropriate strategy for your business's bespoke needs and goals.

FOOTNOTES

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DISCLOSURES