Business Matters

WINTER 2012

WHAT'S AN OWNER WORTH?

Setting a reasonable salary for yourself

During the current economic downturn, some business owners have voluntarily — or involuntarily — taken a pay cut to keep their company afloat. This is an acceptable short-term strategy, but it's important for owners to pay themselves what the IRS calls a "reasonable" salary. S corporation owners, in particular, can get into trouble if their salaries are too low.

Owners who pay themselves generously should also beware. In a recent Tax Court case, *Multi-Pak Corp. v. Commissioner*, the IRS challenged a C corporation owner for paying himself excessive compensation to reduce his company's tax liability.

You should, therefore, try to strike a balance between under- and overpaying yourself.

SPECIAL RULES FOR START-UPS

If you're just starting out, setting your salary is relatively easy. Pay yourself enough to cover your bills and living expenses — and no more. You can increase your salary as your business grows by pegging it to profit growth.

Even if you have another source of income, resist the urge to pay yourself nothing. Lenders and investors expect to see salary projections in your financial statements. It helps them estimate when you'll be profitable and able to repay debt, and it shows them you're realistic about what it costs to run a business over the long term.

MATURE BUSINESSES

If your company is safely in the black, determining your salary can be more complicated. This is particularly true if you run an S or C corporation, where the owner's compensation affects tax liability.

Some owners set their salary based on informal metrics, such as what they were paid as an employee elsewhere, what they think they're worth or even what their friends and business peers would expect them to earn. A more reliable method is to incorporate factors that the *Multi-pak* court considered when determining reasonable compensation. Consider, for example:

Your role. Take into account your responsibilities, hours worked

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6777 Wadsworth Blvd • Arvada, CO 80003 • 303-469-0012 • efmcpa.com

PROTECTING YOUR BUSINESS WITH LIFE INSURANCE

You know you need life insurance to provide your dependents with financial security should you die unexpectedly. You may be less familiar, however, with how life insurance can help protect your business.

FUND A BUY-SELL AGREEMENT

A life insurance death benefit is an excellent funding option for buy-sell agreements. Such an agreement provides many benefits (see "Why a buy-sell agreement?" at right) but it won't be useful if, when an owner departs, the remaining owners can't afford to buy back his or her shares. That's where life insurance comes in.

Take, for example, Mike, Debbie and Bill, fictional partners in a small manufacturing company. Each owns a life insurance policy equal to the amount of his or her share in the business and has named the other two as beneficiaries.

Life insurance is the only funding option that virtually guarantees that the full buyout amount will be available immediately upon your death.

When Mike dies unexpectedly, the insurance company pays death benefits to Debbie and Bill, who use the money to purchase Mike's shares from his estate. Not only does this keep the company running smoothly, but it gives Mike's family almost immediate access to liquid assets.

KNOW THE ADVANTAGES

Business owners can fund a buy-sell agreement with other sources. But life insurance offers several advantages. Probably most important, it's the only funding option that virtually guarantees that the full buyout amount will be available immediately upon your death. (This assumes your policy offers sufficient coverage and you've made timely premium payments.)

Also, death benefits aren't subject to income tax so long as the policy is properly structured. Thus, the

full proceeds will be available for the buyout. And, if a premature death occurs, the total premiums paid on a life insurance policy normally are a fraction of the cash received as a death benefit.

What's more, if you own a permanent policy that accumulates cash value, this amount also is figured on a tax-advantaged basis. The cash value may be available to help you fund a buyout during your lifetime so that you can retire or move on to other business ventures.

REVIEW PERIODICALLY

You'll need to review your life insurance policy and buy-sell agreement, along with the value of your business, periodically — say, once a year — to ensure the policy proceeds will be adequate when the time comes. As your business grows, changes direction and even welcomes new owners, you may have to change the benefit amount of your insurance policies. ■

WHY A BUY-SELL AGREEMENT?

A buy-sell agreement enables a business with multiple owners to specify how company shares will be valued and how and to whom they can be sold or transferred should one of the owners die or wish to sell. This legal document is essential to protecting your business from unwanted shareholders (such as competitors or family members), costly disruptions — even financial ruin.

5 TIPS FOR GETTING A BUSINESS LOAN

If you're a business owner, you likely know that bank loans remain difficult to obtain. But "difficult" doesn't have to mean "impossible." When applying for a loan, doing the following can improve your odds of succeeding:

1. Choose the appropriate bank. Many lenders specialize, so make sure the bank you approach does business with companies of your size and industry and for the amount you're seeking.

2. Show good character. Lenders make loans to people they trust. Check that your personal and business credit records are free of damaging errors. And when meeting with bankers, always speak, act and dress professionally.

3. Prepare paperwork first. Don't waste your banker's time. Be prepared with a detailed business plan and complete your loan application with all supporting documents *before* you meet with a potential lender.

4. Anticipate questions. Lenders will ask how much you need, what you'll use it for, and how and when you'll repay it. Be prepared with detailed answers.

5. Be confident. Loan officers will take their cue from you, so avoid making negative or apologetic comments about your business and application. Exude enthusiasm and confidence and you're more likely to gain lenders' trust.

TAX SAVINGS BEGIN IN YOUR HOME OFFICE

The home office deduction is an important tax break associated with self-employment. But not all home offices qualify. And many self-employed individuals don't know which expenses they're allowed to write off — and which ones might raise red flags.

3 RULES

Your home office needs to meet three conditions to qualify for the deduction. It must:

1. Be used regularly for business. The IRS doesn't provide a clear definition of "regular use" but says that business use must be more than incidental or occasional and that the facts and circumstances must be considered.

2. Be used exclusively for business. The space must be used only for business — not also as a guest room or for household storage or even as an area to pay personal bills. If you use a room for multiple purposes but use the desk in the corner exclusively for business, you can claim the desk's space as long as it meets the other two conditions. You may, however, be able to deduct expenses for space used regularly but *not* exclusively for business storage.

3. Be your principal place of business. If you also conduct business elsewhere, your home office generally must be where you perform administrative tasks such as bookkeeping. It's also considered "principal" if you regularly meet clients there or it's a separate structure.

Keep in mind that special rules apply to certain businesses, such as day-care services.

WHAT'S ELIGIBLE?

If your home office meets the three conditions, you can deduct expenses such as mortgage interest and real estate taxes or rent, insurance, and utilities based on the percentage of your home used for business. You may also be eligible for a depreciation deduction.

You may be able to write off equipment such as phones, computers and the services that support them, but be careful. If, for example, you use your laptop for business but your spouse also regularly checks personal e-mail on it, you can claim only the percentage of time the computer and Internet service are used for work.

BETTER SAFE

Although you don't want to pass up possible deductions, it's better to be safe than sorry. Keep detailed records and copies of all bills and receipts related to your home office, and avoid claiming more in home office expenses than actual business income. That's an IRS red flag. To learn more about home office deduction dos and don'ts, contact us. ■

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Arvada, CO 80003

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and the value you bring to the business, such as your reputation and customer relationships.

What others pay. Find out what owners in your industry, in your geographic region and of similar-size companies pay themselves.

Character and condition. Consider your company's size as measured by sales, net income or capital value; the complexities involved in running it; and general economic conditions.

Internal consistency. Compensation should be fairly consistent year to year. Dramatic increases or cuts can be an IRS red flag. Your salary also should bear some relationship to those of your employees.

Potential conflicts of interest. The IRS looks out for C corporation owners who disguise nondeductible corporate distributions as compensation. S corporations raise red flags for doing the opposite — reducing salaries and bonuses and instead paying owners via distributions. By taking a lower salary, the owners are able to reduce, often significantly, their payroll tax liability.

STAY IN CONTROL

Don't let salary issues jeopardize your business's — or your own — future. Given the complexities, owners of C or S corporations need to get professional tax advice when determining the amount, form and timing of their compensation. ■

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