

CHAPTER 6

INCOME TAXES

Eventually you will have to deal with income taxes. The income tax laws are extensive and can be confusing for an individual starting a business. This chapter does not cover all the tax ramifications of a new business, however it provides some guidance on complying with the laws. A qualified CPA or tax attorney should be consulted when you are dealing with income taxes. Income taxes have a direct result and a potentially significant impact on the cash flow of your business.

Income Tax Forms

Each type of legal entity is required to file a different type of income tax form.

Corporation. A corporation is considered a taxable entity and is required to file a Federal Form 1120 and Virginia Form 500. Blank copies of Federal Form 1120 and Virginia Form 500 are in the Exhibit Section.

Partnership. A partnership is not a taxable entity. It is treated as a conduit through which taxable income is passed to the individual partners for inclusion in their respective tax returns. The partnership is required to file Federal Form 1065. No tax is due with this form. However, included with the forms is a schedule K-1 which lists the various items of income and credits to be included on the individual partner's return. Blank copies of Federal Form 1065 and Virginia Form 502 are in the Exhibit Section.

S Corporation. An S corporation is a type of corporation that is specially treated under the tax laws. The government taxes this type of entity in the same manner as a partnership, with certain exceptions. The tax forms required are Federal Form 1120S and Virginia Form 502. Blank copies of Federal Form 1120S and Virginia Form 502 are in the Exhibit Section.

Sole Proprietorship. A sole proprietorship is considered to be a component of the individual's personal tax situation. The tax form required is the Schedule C which is included with the owner's Form 1040. In addition, if the business has net taxable income, then a Schedule SE must be prepared to determine the amount of self-employment tax that is due. Virginia follows these same rules with the exception of the self-employment tax which is not levied under the Virginia tax laws. A blank copy of Schedule C is in the Exhibit Section.

Limited Liability Company. This is a new form of business organization and if properly structured, is treated as a partnership for Federal income tax purposes. The tax forms required are Federal Form 1065 and for Virginia, Form 502 (See Exhibit Section).

Estimated Tax Payments

In addition to the regular tax forms, the law requires that if an estimate of the tax is not properly prepaid on a quarterly basis, a non-deductible underpayment penalty will be levied. Since an estimate is based on forecasting the future, and liable to human error, the tax laws provide two safe-harbors to avoid the penalty for underpayment.

Individual Estimates. If an individual's payments for each quarter equal the lesser of 100% of the prior year's tax or 90% of the current year's tax, then the penalty can be avoided. In some cases individuals may have to pay 110% of the prior year Federal tax liability to avoid the penalty.

Corporate Estimates. Corporations that had tax of at least \$500 or more in the prior year or taxable income of over 1 million taxable income in the prior year, must pay at least 100% of the current year tax to avoid an underpayment penalty.

Estimates are filed using the following forms:

<i>Corporate</i>	Beginning January 1, 2011, all taxpayers that are required to make tax deposits must use the Electronic Funds Transfer Payment System (EFTPS). Virginia Form 500-ES.
<i>Individual</i>	Federal Form 1040-ES. Virginia Form 760-ES.

Due Dates

The due dates of the various Federal and Virginia forms are:

<i>Corporate</i>	Federal Form 1120 is due the 15 th day of the 3 rd month after the end of the tax year. The Virginia Form 500 is due the 15 th day of the 4 th month after the end of the tax year. The Federal EFTPS and Virginia Form 500-ES are due the 15 th day of the 4 th , 6 th , 9 th , and 12 th months of the tax year.
<i>Partnership</i>	Federal Form 1065 is due the 15 th day of the 4 th month after the end of the tax year (April 15 th for most partnerships). The Virginia Form 502 is due the 15 th day of the 4 th month after the end of the tax year.
<i>S Corporation</i>	Federal Form 1120S is due the 15 th day of the 3 rd month after the end of the tax year. The Virginia Form 502 is due the 15 th day of the 4 th month after the end of the tax year. If required, use the Federal EFTPS and Virginia Form 500-ES are due the 15 th day of the 4 th , 6 th , 9 th , and 12 th months of the tax year.
<i>Sole Proprietor</i>	Federal Form 1040 is due April 15 th and Virginia Form 760 is due May 1 st . Estimated tax payment Forms (Federal Form 1040-ES and Virginia Form 760-ES) are due quarterly on April 15 th (May 1 st for Virginia), June 15 th , September 15 th , and January 15 th .
<i>Limited Liability Company</i>	May be classified as a partnership or corporation for Federal income tax purposes. Filing dates also vary by state.

Extensions

The business owner may request an extension of time to file the tax returns. However, these extensions do not extend the time for paying the tax.

First Corporate Return

The first tax return a corporation files is very important. As part of that return elections are made which will dictate the way the corporation is taxed for many years to come. A couple of the more significant elections that may need consideration are outlined below:

Election to capitalize and amortize costs incurred to organize the business. These can be legal, accounting or similar fees paid to commence operations. Such costs are not normally considered expenses of the corporation and are not deductible unless this election is made.

Election to accrue vacation pay earned but not taken by employees at the end of the tax year. Without this election, vacation pay is not deductible until the year it is taken.

The elections discussed above are only a few of those that may need to be considered in an initial return. A qualified tax practitioner can help plan how best to utilize elections to take advantage of some of the following provisions of the Federal and Virginia tax laws including:

- A. Net-operating loss carryovers
- B. Research and development tax credits
- C. Last-in-First-out inventory method
- D. Virginia tax credits

Tax Planning

Proper tax planning is essential in order to make the most of the income tax laws. You will probably need to develop a relationship with a qualified CPA who has experience with the taxation of your type of business. Tax planning is not a one-time shot right before the return is due. Tax planning is a year-round endeavor requiring communication on both sides - you and your CPA. Proper planning ensures that there are no surprises when the return is filed.

State Taxes

If your company will be doing business in more than one state, it is essential that you familiarize yourself with the tax laws and filing requirements of those states. Each state has its own rules and regulations; if you are in non-compliance, you may be barred from doing business in that state.

Conclusion

Income tax laws are quite complicated. The amount you may save by attempting to tackle your own taxes, particularly as they relate to a business, can be greatly overshadowed by the expense you may incur if you make a mistake. This axiom takes on greater significance when the return is for a corporation - especially the first return. However, a far greater consideration than potential mistakes, is missing opportunities which may be available to you and your business.