



New Hampshire small businesses and reasonable compensation – The new rules

Steven A Feinberg - CPASteve

Submitted at 1/17/12

New Hampshire businesses need to start thinking about documenting what is 'reasonable compensation' to the owners or partners if they are operating as a sole proprietor or partnership.

As an indirect result of New Hampshire introducing and ultimately repealing the so-called LLC tax several years ago, New Hampshire has now enacted new rules giving more guidance over what is 'reasonable compensation' in the preparation of the Business Profits Tax Return. I'm going to try to dumb this whole area down a little, and perhaps try to make all this look a little simpler than it actually is. Devine Millimet was kind enough to provide the specific section of New Hampshire's statutes that I'm referring to.

What's the problem, you wonder? Well, the New Hampshire Business Profits Tax (BPT) is a tax of 8.5% on the income of your business. So, if you made \$40,000 as a sole proprietor from your dry cleaning business, you would have to pay \$3,400 to New Hampshire as BPT tax. However, because we have no 'income tax', the state permits you a deduction against that \$40,000 for 'reasonable compensation', resulting in NO business profits tax owed. Now, New Hampshire has enacted new rules giving specific guidance on what reasonable compensation is.

Let's start with the safe harbor.

First, if the profit we're talking about is due to a sale of assets, an amount not to exceed

15 percent of the gross selling price as a commission on that sale is permitted, no questions asked.

Second, A business organization or group of related business organizations may elect to deduct up to \$50,000 as total compensation for the tax year, again no questions asked. This should be good for many sole proprietors, but will undoubtedly cause problems for partnerships since the safe harbor is for the entire organization, provided at least one partner or member of an LLC performed personal services for the business organization or group of related business organizations.

In an article written by Maurice Gilbert, Director of state taxation for Devine Millimet, he states "...It is clear from these statutory changes to the BPT that business organizations will be required to maintain supporting documentation for any compensation deduction taken for proprietors, partners and members of limited liability companies that is greater than the recordkeeping safe-harbor ... Failure to maintain supporting documentation could result in a complete disallowance...".

So, what are some things that Mr Gilbert suggests that the business owner could do to help build a case that their owner, member, or partner compensation is reasonable? Guidance is limited, but this might include:

- Using employment agreements that identify key services provided and the methodology for compensating the individual for such



services. This could actually be a huge argument that all affected businesses in New Hampshire should be operating as an LLC or some other incorporated entity, since a sole proprietor could not enter into such an agreement.

- Retaining any personal calendars, appointment notes, comments entered on the owner-employee's PDA devices, such as their I-Phone or Blackberry, regarding business activities or other business records that demonstrate the activities of the owner-employee. Examples of such records may be sales reports in the case of an individual who is involved in the marketing side of the contracts or other agreements requiring the skills of the owner-employee that may have been negotiated by the individual during the taxable period or other business documents that support the owner-employee's key efforts.

- Compensation paid by a similar company to its owner-employee could establish the reasonableness of a deduction, provided you can get your hands on what that would be.

- Comparing the compensation methodology for the owner-employee and other employees of the business also

provides potential support for the compensation level of the owner-employee. A business that provides, for example, significant bonuses to key employees, other than the owner, for their contributions can support the reasonableness of a compensation plan that includes significant bonuses to the owner-employee.. or

- Documented discussions with your tax preparer exploring the value of your services for the year.

Many small business owners are going to want to ignore this., but one thing to realize is that before these rules were instituted, the burden of proof was on the state. That burden has now been moved to the taxpayer, so absent ANY proof could be a real problem.

There are also a couple of other techniques that I can see being very useful in avoiding a challenge, but you'll have to call me and we can meet to discuss those further!

Steven A Feinberg, CPA of Appletree Business Services LLC, a PASBA member accountant, located in Londonderry, New Hampshire, has more than twenty five years experience in Federal and New Hampshire issues, specializing in small business general, tax and payroll matters. For additional information on these and other current business and tax issues, email Steve at info@appletreebusiness.com or call (603) 434-2775.

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Tax Deductions that small businesses often mess up on

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Submitted at 1/9/12

According to National Federation of Independent Business (NFIB), here are a few tax deductions that small business owners often make mistakes with:

- **Mileage:** Be sure you're deducting trips to meet with clients, run work-related errands and attend meetings and networking events, particularly with personal vehicles. You will need to log the date, destination, and start and end mileage for each trip. It's always a good idea to keep some sort of mileage log that documents the use of your vehicle for business.

- **Asset deductions.** Section 179 of the IRS Code allows small businesses to take a depreciation deduction for certain capital expenditures in one year, rather than depreciating them over a longer period of time. If you've been hit hard by the recession, that could allow you to keep a bigger chunk of money in the short run. Most tax preparers will automatically try to take the Section 179, 'if they know

about it'. In certain situations though, you may not realize that you have larger deductions available, such as if you were to enter into a LEASE for equipment (you will rarely see auto loans like this) that is eligible to be capitalized, where the lease calls for a purchase amount at the end of the lease for substantially less than fair market value, typically a dollar or so. So, make sure your accountant/tax preparer is provided copies of any significant purchases.

- **Specialty items.** If you own a building, you may be entitled to state and federal tax savings for building improvements, like adding special wiring or a soundproof room. Certain assets related to such projects qualify for accelerated depreciation, meaning you can take larger tax deductions over a shorter period—increasing your cash flow and lowering the cost of capital in the years following the project.

- **Charitable donations.** Sometimes it may make sense for the business to make the charitable deduction rather than it coming from personal

funds. It's always best to see if there's a business purpose to the contribution, such as advertising. If it's not a business expense, then the question is whether a charitable contribution in the name of the business makes more sense. If your company makes the donation, it can take a deduction and lower both its federal and state taxes. The less money your company makes, the less you will be taxed on your Form 1040, particularly if it can reduce your wages if you receive a W-2 as an employee.

- **Bad debts.** If someone owes you money you cannot collect, you may be able to deduct that as "bad debt" as an expense on your business tax return. While bad debts are mainly the result of credit sales to customers, according to the IRS, they can also be the result of loans to suppliers, clients, employees or distributors. Keep in mind however, that in order to be able to deduct bad debts in your business, you generally can not be a cash basis taxpayer.

- **Supporting items.** Remember

to file receipts for any purchases that are related to your business. Expenses related to conferences, new software and accounting services are frequently overlooked.

- **Loan interest.** Have you borrowed money against a personal loan, like a mortgage, to purchase equipment for your business? You can write off the interest on personal loans, provided you've invested the money into your company. Just be sure to document how it was used in case of an audit.

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Making the right pricing decisions for your New Hampshire small business

Steven A Feinberg - CPAsteve

Submitted at 1/5/12

Are you making the right pricing decisions for your business? In business, making pricing decisions is always tough – and even more so when the economy is slow and sales are slipping. It's tempting to cut prices hoping to generate higher sales volume. But sometimes that just produces lower margins on a low volume.

What do you do if you're being squeezed by cost increases? Can you increase prices in a slow economy?

How do you respond if your customers complain? Can you justify holding prices steady if your competitors cut their prices? There are no easy answers, but running through a three-step process can help you make the right decision.

- **Know your strengths.** How does your product or product range stack up against the competition? Are your products higher quality, lower quality, or indistinguishable from your competitors' products? Do you have an edge that can justify higher prices? How about all the other elements that make up your



total service package? Do you provide a bigger inventory, faster delivery, better payment terms, wider product line, better service on returned items? If not, can you change your operations to gain an edge in any of these areas? Consider holding a brainstorming session with your salespeople to go over these questions. The

answers might point the way to pricing decisions, and they'll certainly give you good replies to customer pricing objections.

- **Put yourself in your customers' shoes.** Try to understand your customers' needs. Are they under profit pressure? What changes are occurring in their industry? How can you adjust your products or service to add value for them – value that they might be willing to pay for? What are their alternatives

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How can I take a tax deduction for the food I eat?

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Submitted at 2/2/12

Everybody would love the opportunity to take a tax deduction for the food they eat, but unfortunately there are only a few instances that actually allow it.

If you are an employee, and you have lunch every day at the company cafeteria or local eatery, you're generally out of luck, unless your food is eaten as part of your employer's business (i.e. entertaining clients, out of town trips, etc.), and even then the food becomes only 50% deductible. Similar rules would apply if you're self-employed, as well.

Generally you cannot deduct food as a medical expense, even if you could argue you need it to stay alive, and therefore it's medically necessary. However, what happens if a doctor prescribes a special diet such as a gluten free for sodium free diet? These diets do tend to be very expensive, often requiring special foods that are typically higher in cost. Given these circumstances, the cost of the food in 'excess' of your



normal diet would be tax deductible.

How does this work? Well, let's say that you were on a gluten free diet. You can't buy flour that is 'wheat' based, but instead must buy flour that is 'oats' based, a more expensive alternative. Provided that you have a doctor's prescription proving the medical necessity of a gluten free diet, you would be entitled to tax deduction for medical expense of the difference between the cost of the traditional 'wheat' based, and the higher priced 'oats' based flour. Obviously, you'd also need to have pretty good records proving that you actually purchased the 'oats' based flour, and have some proof as to how much the 'wheat' based flour would cost if you purchased.

Keep in mind that medical deductions can only be deducted as an itemized

deduction, so it's of no value or limited value if you're not itemizing already, and can only be deducted as a medical deduction if your total medical expenses exceed 7.5% of your adjusted gross income, and then only that amount in EXCESS of the 7.5% is the itemized deduction.

So, you've got a few hoops to jump through, but it can be done with proper documentation. Contact your tax adviser for more information.

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if you raise prices? If your salespeople are staying in touch with their customers, they should already have the answers to many of these questions.

- Know your competition. Run through the same questions you asked about yourself and apply them to your competitors. What are their strengths and weaknesses? What can they offer your customers that you can't? How will they respond if you change prices? Here again, your sales staff should have good information on the

competition they face. When you've worked through these three steps, you should have a much better idea of the likely competitive effect of a price change. Run some profit scenarios and then review your pricing decision with your salespeople. Make sure they understand the rationale and jointly rehearse how they'll present the change to customers. For assistance with pricing issues in your business, give us a call.

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