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To: Clients, Associates & Friends of Pro@ctive CPA
From: Mark Wyssbrod, Managing Member
Date: October 1, 2012
RE: Same Person No Accountability

Introduction

One reason small businesses are successful is due to their agility: they can adapt to changing economic environments by adjusting their structure, operations and updating business plans quickly! Also, the leadership hierarchy is flattened, allowing for quick adaptations. Although the flattened hierarchy is a great strength, it may also be a weakness because it means the owner, manager, and employee is the same person.

Minimal accountability between these three groups exists in the small business environment. In larger business structures shareholders (business owners) hold the company's managers accountable; and the company's managers hold the employees accountable. Managers cannot raid the company's bank account as their own purposes without shareholder law suits pending. Managers do not issue excess equity distributions (i.e. dividends) to shareholders if it lowers the company's working capital and liquidity to below average (healthy) levels. Managers may pressure the employees to work extra hours and become more efficient.

When the same person is the business owner, manager and employee, a common result, from my observation, occurs: excess debt, excess distributions and minimal liquidity. Why? The accountability between the three is not enforced.

It's time to strengthen our business's financial position by holding ourselves accountable!

Sincerely,

Mark W.

Why Is Documentation Important?

People generally don't like two things: criticism and accountability! However, these two items, when done in the right manner, lead us to be better and stronger individuals and professionals. A part of accountability is to document transaction properly, which can make us better business owners. In addition to this benefit, the legal responsibilities we endure as small business owners and managers might be the best reason to be accountable and document.

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- Compensation agreements need to be documented.
    - A reasonable salary needs to be presented and approved by the company's board.
    - Why?
        - Excess compensation can be disallowed for a deduction by the IRS and\or reclassified as an equity distribution (potentially subject to double taxation).
- Expense Reimbursement Reports need to be turned in, approved and paid monthly.
    - Why?
        - The IRS deems reimbursement paid more than 60 days later are not reimbursements and views them as taxable income subject to self-employment taxes!
- All company loan receivables and loan payables need to be approved by the company's board and documented.
    - Especially, shareholders and related party loans!
        - Why?
            - The IRS states if equity distributions are do not have the correct legal formality (board meeting, voted on and documented) the transfer is not a loan.
        - If a loan receivable
            - According to the IRS, the cash outflow is not a loan or an equity distribution, since loans and equity distributions are required to be documented.
        - Therefore, the loan payments are compensation subject to self-employment.
    - All loans must have a borrower, lender, amount, interest rate, security, payment schedule and date of loan.
        - If a related party and the interest rate is zero, that is OK legally.
            - However, the IRS will force the lender to "impute" interest income and pay tax on this phantom income based on the Federal Applicable Rate (a schedule which the IRS creates).
- Equity distributions need to be approved by the company's board and documented.
    - Why?
        - The IRS states if equity distributions are do not have the correct legal formality (board meeting, voted on and documented) they are not distributions.
        - According to the IRS, the cash outflow is not a loan either, since loans are required to be documented.
        - Therefore, the distributions are compensation subject to self-employment.

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There are lots of moving parts when running a business. Generally, business owners like the sales and leadership, but avoid the administration and paper work. However, these are critical areas for all business owners to practice.

Please contact me if you would like to learn more!

- October 1 - Final day to set up SIMPLE IRA for small businesses for 2012
- October 15 - Final individual tax return filing deadline for 2011
- December 31 - S-corporation owners must report health insurance in W-2 for favorable tax treatment
- December 31 - Deadline to set up SEP, 401(k) and other retirement plans. You may need to fund the plans by this date as well
- December 31 - Final day to set up a retirement plan for 2012 and certain employee benefits for 2013 for small businesses

Financial Ratio Of The Month -

Debt to Equity Ratio

This Balance Sheet leverage ratio indicates the composition of the company's total capitalization (the balance between money or assets owed versus the money or assets owned).

DtE = Total Liabilities / Total Equity

Generally creditors prefer a lower ratio to decrease financial risk while investors prefer a higher ratio to realize the return benefits of financial leverage. During this era of deleveraging, the lower the ratio the better and safer!