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## For Your Information

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## STEPS IN STARTING A BUSINESS

Whether you are starting your business from scratch or buying an existing business, there are a multitude of decisions to make and things to do. This section is to help you organize and plan the steps needed. (By the time you are reading this you are probably past the first several steps.)

1. Choose an enterprise that is of personal interest to you. Determine if there is a market for your product or service.
2. Look for any businesses for sale. Visit a business broker even if you are going to start from "scratch". Develop your business plan with your accountant's assistance. Schedule the events needed to get the doors open
3. Study your market. Target your particular market and profile your target customer. Develop a sales projection.
4. Analyze potential locations. Discuss leasing/buying specifics with property owner. Review potential lease/purchase opportunities with attorney.
5. List personal assets and sources of capital. Prepare list of capital needs for new business. Discuss financing with banker. Discuss form of business with attorney and accountant.
6. Design the interior layout and floor plan to meet your business needs. Draw up a list of initial furniture, fixture, and equipment needs. Have your accountant assist in developing a budget.
7. Plan first year advertising and promotion calendar. Draw up advertising copy. Contact media choices for rate schedules and special programs that are of interest to your target customer.
8. Research any sales training programs. Develop a sales philosophy. Develop customer relation policies. Develop a compensation and evaluation for salespeople.
9. Research your industry for pricing strategies and choose the one most suitable for you.
10. Develop an organizational chart. Write out job descriptions. Determine pay scales, benefits and training requirements.
11. Develop Cash Flow Chart. Discuss with banker short-term line of credit. Decide if you will need the use of bankcards or an accounts receivable system.
12. If your business involves inventory, plan initial purchase and first buying season after your initial opening. Go to industry trade shows. Develop a strategy to use if too little or too much inventory.
13. Meet with your accountant to set up bookkeeping system. List all registrations, forms, and procedures need that to be completed before opening.
14. Investigate computer capabilities for now or future.
15. Obtain necessary insurance coverage.
16. Design a timetable for business expansion.

## **A BUSINESS PLAN**

A business plan is a set of management decisions outlining what the purpose of the firm is and how it will fulfill its goals. The decision-making process begins long before the first day that the doors are opened for business and is a continuing process of choice, planning, implementation and evaluation during the firm's life.

Having a clear business plan provides several benefits to the new business. A business plan can;

1. Improve performance by identifying both the strengths and weaknesses of the firm's operation and identify potential problem areas,
2. Communicate clear expectations to the employees regarding the firm's performance and priorities,
3. Provide a solid basis for measuring performance and establishes a framework for decision-making, and
4. Be used to communicate the objectives, structure, planned actions and performance of the firm to outsiders to gain their financial and non-financial support.

Whether as a formal document to be presented to outsiders or as notes for management's use only, every business plan should include:

1. A mission statement which expresses the entity's overall purpose and reason for being,
2. Goals clearly and concisely stated, and
3. List of programs, projects and tasks to be undertaken to accomplish the goals. The projects and tasks should specify responsibility and follow-up dates to allow for evaluation of progress.

By having a comprehensive set of goals, the foundation for developing effective business strategies has been laid. First, the mission, or overall purpose of the firm, needs to be defined and stated. Next, goals must be set for each basic area to establish performance standards for current and future periods. Finally, each set of goals needs to be developed into specific objectives and strategies, spelling out in very specific terms the performance objectives and providing a clear, overall indication of how those objectives will be accomplished.

When developing goals for the firm's short and long term performance, five general areas need to be considered:

1. The target market and marketing;
2. Production and/or service;
3. Research and development;
4. Organization and management; and
5. Budgeting and finances.

The financial plan, or budget, is developed using the information obtained from the objectives and strategies of the other basic areas. An analysis of this financial information provides an indication of the adequacy and attainability of the objectives using the available financial resources. It may be necessary to re-evaluate and revise the operating objectives to obtain a more satisfactory financial plan.

The development of proforma financial statements provide valuable information by reflecting the impact of different levels of operations on the cash flow, net income and net worth.

Projected monthly cash-flow statements, and quarterly income statements and balance sheets are useful as a measurement against the actual financial results and provides insight into problem areas.

## **TAX AND LICENSE REQUIREMENTS**

The various local, state and federal governments require businesses operating within their jurisdiction to meet certain tax and license requirements. Contacting your local government to discuss these requirements is usually the best method to insure compliance.

We have summarized the most common requirements placed on small businesses and the phone numbers for the local government offices.

### **Partnership or Trade Name**

Businesses using a trade name must register with the Clerk of the Court. A small fee is usually required.

### **Corporations**

All corporations conducting business in Virginia must register with the State Corporation Commission. To register or to incorporate contact:

State Corporation Commission

Box 1197

Richmond, VA 23214

### **Certificate of Occupancy**

Most businesses, including home occupations, must obtain a use permit, certificate of occupancy or home occupation permit. The local Zoning Administrator must verify that the proposed use is in compliance with all zoning ordinances and this may take from 7-14 days.

### **Business Licenses**

All individuals, partnerships and corporations physically located in or doing business in the local cities, towns and counties are required to obtain a business privilege license. The fee for this license is based on type of business and the gross receipts of the business.

Many businesses, or the individuals in the business, are also required to have state and federal licenses.

### **Retail Sales Tax**

Every retail dealer must register with the State and collect retail sales tax. Reports must be filed and the tax paid monthly or quarterly depending on the volume of business.

## **Consumer Use Tax**

The Consumer Use Tax applies to all tangible personal property used or consumed within the state but was purchased outside the state, would have been subject to sales tax if it had been purchased within the state, and no state sales tax was paid. This tax also applies to any purchase within the state but on which the applicable sales tax was not paid. A report must be filed and the tax paid by the 20th day of the month following the month in which the liability occurred.

## **Business Tangible Personal Property**

Businesses owning tangible personal property, furniture, fixtures, machinery, tools and vehicles are required to file a tax return itemizing the property, giving the date of acquisition and original purchase price. The due date of this return and payment of the tax varies with each jurisdiction.

## **Workers' Compensation Insurance**

Any employer who has three or more regular employees is required to furnish workers' compensation insurance coverage at no cost to the employees. The insurance may be purchased through a private insurance company or the employer can apply to the Industrial Commission to be a self-insurer.

The Industrial Commission of VA  
P.O. Box 1794  
Richmond, VA 23214

## **Federal Employer Identification Number**

Every employer is required to have a federal employer identification number. To apply, use form SS-4, which can be obtained from any Internal Revenue Service office.

## **Employment Taxes and Income Tax Withholding**

Employers are required to withhold Social Security (FICA) and income taxes from the wages of employees. The employer can be held liable for the taxes whether or not they were actually withheld. Internal Revenue Service requires a quarterly employment tax return to be filed and taxes paid at intervals determined by the amount of tax collected. (For additional information-see Payroll Tax Deposit Requirements). The states require a return and taxes paid on a monthly or quarterly basis, depending on the amount withheld.

## **Unemployment Taxes**

Employers are required to pay an unemployment tax at both the state and federal levels. Internal Revenue Service requires quarterly deposits at authorized banks and an annual tax return. The states require a quarterly return with payment of tax. For most states, this tax is based on a percentage of each employee's first \$7,000 or \$8,000 earned in a calendar year.

## **Income Tax**

Proprietorships, partnerships and corporations have an obligation to file and pay income taxes. However, the form of business determines who pays the tax and how it is reported.

Proprietorships include Schedule C and SE in the proprietor's individual income tax return and the proprietor is responsible for payment of income and self-employment taxes.

Partnerships and Sub-Chapter S Corporations have tax returns prepared at the partnership or Sub-S Corporation level. Partners and shareholders receive a Schedule K-1 from the business entity and then report their share of income and deductions on Schedule E in their personal tax returns. They are responsible for payment of income tax. Partners may also be responsible for self-employment taxes.

A Sub-chapter S corporation may be subject to a special tax on long-term capital gains and excess passive investment income.

Corporations have a corporate tax return, which must be filed. Corporations are required to pay taxes at the corporate level. Shareholders are taxed on dividends distributed to them.

## **INSURANCE COVERAGE**

The purpose of insurance coverage is to provide protection against those losses that may occur which the individual or business could not afford. Therefore, there must be a reasonable correlation between the cost of the insurance and the probability of the loss occurring. If the probability of sustaining the loss is exceptionally low, then so should the premium to cover such a loss.

When shopping for insurance coverage we suggest that at least three insurance agents be interviewed. You may want to interview at least one agent who represents more than one insurance company. During the interview, investigate ways available to reduce the premium, such as having a security system installed, and any discounts available.

Have the insurance agent work with you to determine what insurance requirements you may have. Virginia state law requires workers' compensation insurance for employers with at least three employees. Under your lease or loan agreement, your landlord may require liability insurance or a lender may require insurance on property used as collateral. Also, have the agent review what coverage the business may need that is not required by law, such as, group term-life, disability, multi-peril property and medical.

Premiums for workers' compensation are set by state law, however, you often have room for negotiation and costs may vary on other types of insurance coverage. A good insurance agent will work with you to save money.

## HOW TO MAINTAIN YOUR CHECKBOOK

When having our firm maintain your ledger, your check-stubs are our primary source of information for your record-keeping system. It is vital that these are maintained in such a manner that the bookkeeper can correctly post your cash receipts and disbursements.

Each check-stub needs to clearly indicate the date, to which the check was written, the purpose of the check - indicating to which account the check is to be posted, and the amount of the check. Being familiar with what are tax deductible expenses, what items must be capitalized, what items require special handling for tax purposes and your chart of accounts will enable you to provide a succinct description for the bookkeeper.

Items that require special attention include insurance premiums, auto expenses, travel and entertainment expenses and capital purchases. Each of these items requires additional information to insure proper handling by the bookkeeper. For example, certain insurance premiums are not tax-deductible while others are partially deductible, new restrictions make certain entertainment expenses partially deductible, auto expenses are only deductible for that percentage that the vehicle is used for business purposes, and many capital purchases require additional documentation for the bookkeeper.

The check-stubs also record the deposits made to the account. Most deposits are income from the ordinary course of business and a description or detail is not necessary. However, it is important to separately deposit any money that is received from sources other than as income in the ordinary course of business. These deposits need to be described as to what they are; e.g., loan proceeds, refunds from suppliers, tax refunds, or the owner making a loan to the business. Often additional supporting paperwork will be required by the bookkeeper for these items.

It is important that a balance be reflected in the checkbook at all times, the checks are kept in numerical order, and that all transactions be kept in chronological order. We suggest that voided checks be stapled to the check-stub.

When we are maintaining your ledger, we request that you have the bank send the bank statement directly to us. You send the check stubs, invoices for any capital purchases and loan agreements to us. We will reconcile your bank account and provide you a statement of any corrections required to your checkbook balance.

## HOW TO MAINTAIN A PETTY CASH FUND

Every business has those little, unpredictable expenses that seem to arise at inconvenient times. To handle these with the least amount of bookkeeping, check writing and trouble, we advise a petty cash fund and the following procedures.

1. Determine the amount of petty cash required.
2. Write a check to "Cash" to establish the petty cash fund.
3. Store the cash in a locked box under the control of a trusted employee.
4. As cash is required, the petty cash fund is used. After each purchase, the receipt for the item and any change are returned to the box.
5. As the cash in the fund is depleted, gather all the receipts and total them. Write a check to "Cash" to replenish the fund for the total of the receipts. This will return the Petty Cash to its original amount. The check-stub should record the type of expenses being reimbursed by category and amount; i.e., office \$25.38, auto \$10.00, repairs \$25.00. The total of the check issued to replenish the petty cash fund is \$60.38.

At any given time the total of receipts and the cash in the box will total the full amount of the petty cash fund.

## INDEPENDENT CONTRACTOR OR EMPLOYEE?

Properly classifying a worker as an independent contractor may save your company money and benefits, such as pension, group health, workers' compensation insurance, social security taxes and unemployment taxes. Classifying workers as employees requires you to withhold social security, federal income and state income taxes and file payroll reports. You are liable for FICA and unemployment taxes. Employees may also have rights to various fringe benefits.

Intentionally misclassifying employees as independent contractors may result in substantial penalties and interest, double the amount that should have been withheld by the employer from the employee's wages. Unintentional misclassification of an employee is serious, but not as serious as the risk for an intentional misclassification.

An unintentional misclassification of an employee, but having filed a form 1099-MISC, limits the employer's liability for income taxes to 1.5% of the employee's wages. The employer's liability for FICA taxes that should have been paid by the employee would be limited to 20% of that amount. The employer has no rights to recover from the employee what is due IRS. If the employer did not file a form 1099-MISC, the percentage amounts are doubled. The employer is liable for its share of the FICA and unemployment taxes, plus penalties and interest.

An intentional misclassification of an employee could result in the employer owing IRS the full amount of income tax that should have been withheld (with an adjustment if the employee has paid or does pay part of the tax); the full amount of both the employer and employee shares for FICA taxes (with possibly an offset if the employee paid self-employment taxes); interest; and penalties.

The determination of whether a worker is an employee or an independent contractor usually depends on the extent of control and direction the person receiving the service has with regard to what is done and how it is done. An employer has the right to control how an employee performs the service, while an independent contractor determines for himself how the work is to be performed.

To determine if an individual is an independent contractor, the following 20-Factor Control test should be used.

1. **Instructions.** If the person receiving the benefit of the service has the right to control the manner, the method of performance and when it is performed, this suggests an employer/employee relationship.
2. **Training.** Individuals who are trained to perform a job in a particular manner are usually considered employees. An independent contractor does not receive any special training from the purchaser of his services.
3. **Integration.** Whether the service performed is an integral part of the recipient's business rather than an ancillary portion can determine the worker's status. If the services performed are integrated into the operations of the business, this indicates that the worker is subject to control and direction, and therefore, an employee.

4. **Personal Services.** If the business requires that the services be performed in person and the employer has substantial interest in how the results will be achieved, this suggests control over an employee.
5. **Use of assistants.** An independent contractor hires, directs, and pays for his own assistants; supplies his own materials; and works under a contract providing that the worker is responsible only to achieve certain results.
6. **Ongoing relationship.** Whether part-time, seasonal, or just irregular, ongoing work suggests the worker is an employee.
7. **Fixed hours of work.** Independent contractors set their own hours.
8. **Full time work.** This suggests employee status since this controls the time of work and restricts the worker from taking other jobs.
9. **Work location.** If a worker performs services off of the employer's premises, this suggests independent contractor status.
10. **Work flow.** Routines, schedules, and patterns established by the employer for a worker indicate employee status.
11. **Reports.** Requiring written or oral reports suggests employee status.
12. **Manner of payment.** Being paid by the hour, week, or month suggests employee status. Being paid a lump sum for a job suggests independent contractor status.
13. **Payment of expenses.** Who pays expenses indicates who has control - the employer or the independent contractor.
14. **Tools and Equipment.** Whether the worker rendering the service has a substantial investment in his own tools or equipment will also suggest employment status.
15. **Investment.** If the worker has a significant investment in his own work facilities, tools and equipment, this implies independent contractor status.
16. **Profit or Loss.** If the worker performing the service has an opportunity for profit dependent on his management skills and has a risk of loss, this implies independent contractor status.
17. **Multiple clients.** If the worker who performs the services offers such services publicly and practices an independent trade, this indicates an independent contractor.
18. **Marketing.** Independent contractors usually market their services to the public on a regular basis.
19. **Right to discharge.** If the person who receives the services has the right to discharge, without cause, the person who performs the services, there is an employer/employee relationship. An independent contractor usually can only be dismissed if the contract specifications are not met.
20. **Right to quit.** An independent contractor may be liable for failure to perform according to the contractual terms, while an employee may quit any time without liability.

Whether an individual is determined to be an independent contractor or an employee, it is required that you obtain his complete name, social security number and address before any money is paid. If this information is not obtained, you are required to withhold 31% for federal income taxes.

Form 1099-MISC must be filed with IRS for any amounts paid to an individual for services in excess of \$600.00 during the calendar year. The due date for distribution of the form 1099-MISC to the independent contractor is January 31st of the following year. Form 1099 with its transmittal form 1096 must be filed with IRS by February 28th of the following year.

When a worker is correctly classified as an independent contractor, we recommend that you receive a Certificate of Insurance, a copy of the worker's business license, his federal employer's identification number, a business card, and have him provide you a written bill for his services. These documents will help support your position that the worker has been correctly classified, especially if he operates as a proprietorship. They will also help reduce your workers' compensation insurance premiums and unemployment taxes.

## **REQUIREMENTS FOR PAYROLL RECORDS**

The Internal Revenue Service requires every employer to keep all records on employment taxes (income tax withholding, social security and unemployment tax) for at least 4 years after the due date of the return or after the date the tax is paid. In addition, the employer's records need to contain copies of the returns filed and the dates and amounts of deposits made by the employer.

The Internal Revenue Service also requires the employer to keep the following:

1. Each employee's name, address and social security number;
2. Total amount and date of each wage payment and the period of time the payment covers;
3. Amount of social security withholding tax collected and date it was collected;
4. Explanation of any amount of payment to employee not subject to tax;
5. Form W-4, W-4A, or W-5 completed by employees;
6. Any agreement for voluntary withholding of additional amounts of tax;
7. Statements given to you by employees to report their tips;
8. The fair market value and date of each non-cash compensation paid; and
9. The amount you paid to the state unemployment fund.

## **PAYROLL TAX DEPOSIT REQUIREMENTS**

The federal and state governments require most employers to withhold, deposit, report and pay social security taxes, income taxes, and unemployment taxes.

This section tells you about the payroll tax responsibilities of an employer and will summarize the requirements for withholding, reporting and paying taxes. The Internal Revenue Service's Circular E, "Employer's Tax Guide," contains the federal income tax withholding tables and complete information on these responsibilities.

Every new employee must complete a form W-4 or W-4A, I-9 and a state exemption certificate within three days of commencement of work. These forms verify that the employee is entitled to work in the United States, and how many exemptions he or she may claim for withholding purposes.

Wages paid to an employee are subject to social security (OASDI and Medicare) taxes. The wage base and tax rates are adjusted annually and are published in the IRS's Circular E.

There are several methods available to compute the income tax withholding. The most common one is the wage bracket tables enclosed in the IRS's Circular E and similar tables provided by each state.

IRS and the state will send you a coupon book preprinted with your name, address, and identification number. These coupons are to be used to pay the taxes.

The federal tax coupon is used to deposit the employment (and other federal) taxes at your local bank. IRS requires that your local bank receive these taxes rather than having them sent directly to the IRS.

In general, you must deposit backup withholding, income tax withheld, and both the employer and employee social security and Medicare taxes (minus and advance EIC payments) that total \$500 or more by delivering or mailing a check, money order, or cash to an authorized financial institution or Federal Reserve bank.

### **SUMMARY OF DEPOSIT RULES FOR SOCIAL SECURITY TAXES AND WITHHELD INCOME TAX**

Under the rules effective January 1, 1993, you are either a monthly depositor or a semi-weekly depositor. However, if you accumulate taxes of \$100,000 or more at any time during the year, you are subject to the \$100,000 one-day deposit rule. In November of each year, the IRS will notify you to inform you whether you are a monthly or semi-weekly depositor for the coming calendar year. If you do not receive notification, you must determine your own deposit status. If you are a new employer, you are a monthly depositor for the year in which you first become an employer.

You are a Monthly Depositor if the total tax reported on forms 941 for the four quarters in the look back period is \$50,000 or less. (The look back period consists of the four quarters beginning July 1 of the second preceding year and ending June 30 of the prior year. For 1993,

the look back period is July 1, 1991, through June 30, 1992.) As a Monthly Depositor, you must deposit the employment taxes and the taxes withheld on salary and wage payments made during a calendar month by the fifteenth day of the following month.

You are a Semi-Weekly Depositor if the total tax reported on forms 941 for the four quarters in the look back period is more than \$50,000. If you are a Semi-Weekly Depositor, you must deposit the employment taxes and the taxes withheld on salary and wage payments on Wednesday and/or Friday, depending on which day of the week you make the salary and wage payments. If the payday is Wednesday, Thursday and/or Friday, the taxes must be deposited by the following Wednesday. If the payday is Saturday, Sunday, Monday and/or Tuesday, the taxes must be deposited by that Friday.

If you accumulate taxes of \$100,000 or more on any day, you must deposit the taxes by the close of the next banking day.

A more detailed explanation of these rules can be found in IRS's Circular E, Employer's Tax Guide. Always refer to the most current issue of this guide for the most up to date rules and withholding tables.

## **A SYSTEM OF INTERNAL ACCOUNTING CONTROL**

Internal accounting controls are designed to process business transactions efficiently and insure a proper accounting of the assets, liabilities, revenues, and expenses resulting from those business transactions.

Whether simple or complex, an internal accounting control system should provide a company with reasonable assurance that:

1. Transactions are carried out according to the owner's or management's authorization;
2. Transactions are recorded in the proper amounts and within the accounting period during which they were executed;
3. Transactions are appropriately classified to facilitate the preparation of financial statements in accordance with generally accepted accounting principles (GAAP) or a comprehensive basis of accounting other than GAAP; and
4. Employees' access to assets is allowed only in accordance with the authorization of owners or management.

An effective system of internal accounting control for a small business with less than \$10 million in annual revenues should have the following basic controls.

### **GENERAL**

Clearly defined duties and responsibilities for all accounting functions. These can be formalized through organizational charts.

An accounting system should exist that obtains the following results:

Complete and updated accounting records;

Periodic balancing of accounting records;

Written procedures describing the purpose of each account and how transactions should be accounted for;

Authorization and approval of all journal entries;

Support for journal entries (i.e., appropriate documentation, such as invoices and bills);

Budgets; and

Competent accounting personnel.

Adherence to policies and procedures, including:

Adequate supervision by owners or managers;

Periodic reviews of transactions and reports;

Prompt corrective action (when necessary); and

Safeguarding accounting records to prevent loss, theft, or destruction.

## **CASH**

Safeguarding cash from theft and establishing accountability for cash receipts by:

Listing mail receipts before turning them over to the bookkeeper;

Tracing mail receipts to the cash receipts journal;

Controlling over-the-counter receipts by using cash register tapes;

Depositing cash receipts daily;

Bonding key employees; and

Assigning two different employees to the preparation of bank deposit slips and the reconciliation of bank records.

Accounting for all cash disbursements by:

Using pre-numbered checks for all disbursements;

Using mechanical check protectors;

Requiring that owners or managers sign all checks;

Assigning responsibility for signing checks to someone who is not responsible for bank reconciliations;

Signing only completed checks (i.e., never signing blank checks);

Documenting all check disbursements;

Retaining all voided checks;

Using a petty cash fund; and

Conducting periodic counts of petty cash.

## **INVENTORIES**

Safeguarding inventories from deterioration, fire, obsolescence, or theft by:

Assigning responsibility for inventories to a qualified employee (note that it must be someone other than the bookkeeper);

Implementing physical controls (e.g., using warehouses or vaults);  
and

Acquiring adequate insurance coverage.

Accounting for all inventory items by:

Conducting physical counts periodically;

Segregating consigned inventory from other inventory;

Authorizing and controlling withdrawals from inventory; and

Preparing perpetual inventories.

Ensuring the accurate recording of all inventory transactions by:

Having formal procedures for physical inventories;

Double-checking physical inventory counts; and

Comparing perpetual inventory records to physical inventory counts.

Maintaining an adequate cost system for determining inventory cost and the cost of sales by:

Matching cost records to the control account;

Reviewing gross profit percentages;

Reviewing overhead rates;

Revising standard costs periodically to insure that they are in line with actual costs; and

Analyzing variances between standard and actual costs.

## **FIXED ASSETS**

Accurately recording all acquisitions, disposals and retirements of property, plant, and equipment by:

Maintaining a detailed plant ledger on fixed assets and depreciation;

Keeping written authorization for capital expenditures and major repairs; and

Applying depreciation rates consistently.

Safeguarding property, plant, and equipment by:

Conducting regular physical inspections of fixed assets;

Having periodic appraisals done for insurance purposes; and

Keeping machinery and equipment tagged and identified by serial numbers.

Ensuring adherence to policies for capital expenditures and for maintenance and repairs by having written procedures distinguishing between those transactions to be capitalized and those to be expensed.

## **REVENUES**

Ensuring that sales are made only to acceptable credit risks by:

Approving credit for all new customers;

Setting dollar limits on credit;

Using a COD sales policy;

Withdrawing credit on delinquent accounts; and

Approving all discounts taken.

Ensuring the accuracy of product shipments by:

Documenting shipping authorizations;

Using a numerically controlled list of sales orders;

Reviewing periodically unfilled orders; and

Checking shipments against sales orders periodically.

Ensuring the proper and accurate recording of invoices prepared for shipments by:

Having numerical control over shipping documents and sales invoices;

Comparing shipping documents to sales invoices;

Reviewing unmatched shipping orders;

Checking the accuracy of sales invoices;

Retaining copies of sales invoices; and

Maintaining a sales journal.

Authorizing and recording accurately all accounts receivable transactions. This can be implemented by:

Maintaining detailed accounts receivable records;

Balancing accounts receivable records periodically;

Mailing statements periodically to customers to confirm outstanding balances;

Requiring approval of all adjustments to accounts receivable; and

Approving all changes in credit terms.

Following up on past due accounts receivable by aging accounts receivable and approving receivable write-offs.

## **EXPENDITURES**

Authorizing all purchases of goods and services by:

Using purchase orders;

Approving purchase orders; and

Reviewing open orders and back orders.

Recording all authorized purchases by:

Matching purchase orders with receiving reports;

Instituting procedures for purchase shortages and for returned or damaged goods;

Keeping detailed accounts payable records;

Controlling accounts payable by periodically reconciling the account with detailed records; and

Matching vendors' statements to recorded payables.

Ensuring that only authorized purchases are accepted and paid for by:

Approving all payable vouchers;

Authorizing check requests;

Inspecting the support for checks before signing them;

Canceling paid vouchers (with a stamp or by perforation); and

Making prompt entries to cash and payable accounts.

## **LABOR COSTS**

Making sure that employees are hired according to company policies and procedures by:

Keeping good personnel files;

Documenting all hiring authorizations, discharges, and changes in salaries; and

Complying with all union agreements and labor laws.

Authorizing all working time by:

Having supervisors approve time cards for production employees;  
and

Having office managers approve time sheets for office employees.

Ensuring that payrolls are properly accounted for by:

Rotating payroll duties;

Reviewing individual payroll records periodically;

Double-checking clerical payroll work; and

Reconciling payroll records monthly.

Ensuring the accurate and timely payment and recording of payroll withholdings by:

Reconciling payroll tax returns to payroll accruals; and

Reviewing payments to employee benefit plans periodically.

## HOW LONG SHOULD BUSINESS RECORDS BE RETAINED?

This schedule provides only a rough guideline to how long certain records should be retained. Your company's particular needs and storage space should be evaluated to determine what is appropriate for your business.

KEY TO NOTATIONS: "AT" Retain AFTER TERMINATION "AD" Retain AFTER DISPOSAL

Articles of Incorporation	Permanently
Bank Statements	7 Years
Deeds	Permanently
Depreciation Schedules	7 Years AD
Dividend Register	Permanently
Financial Statements	Permanently
Fixed Asset Records	7 Years AD
Insurance Policies	3 Years AT
Inventory Records	7 Years AD
Labor Records	See Below
Leases	7 Years AT
Ledgers & Journals	See Below
Stock Ledger	Permanently
Licenses	1 Year AT
Minute Book	Permanently
Mortgages	7 Years AT
Notes (Cancelled)	7 Years
Pension Records	Permanently
Petty Cash Records	3 Years
Plant Acquisition Records	7 Years AD
Securities (Brokerage slips)	7 Years AD
Stockholders Records	Permanently
Tax Records	10 Years
Tax Returns	See Below
W-2 Forms	7 Years

## Labor Records

Applications (Employees)	7 Years AT
Daily Time Reports	5 Years
Disability Claims	7 Years AT
Earnings Records	7 Years
Personnel Records	7 Years AT
Time Cards	5 Years
Unemployment Claims	7 Years AT
Withholding Certificates	7 Years AT
Workers' Compensation Reports	10 Years

## Ledgers & Journals

Accounts Payable	7 Years
Accounts Receivable	7 Years
Cash Journal	10 Years
General Journal	10 Years
General Ledger	Permanently
Journal Entries FYE	Permanently
Payroll Journal	10 Years
Fixed Asset Ledger	Permanently
Purchases Journal	10 Years
Sales Journal	10 Years

## Tax Returns (copies)

Estate	Permanently
Gift	Permanently
Income	Permanently
Payroll	7 Years
Personal Property	10 Years
Sales & Use	10 Years
Social Security	10 Years

## **POTENTIAL IRS EXAMINATION AREAS**

If the Internal Revenue Service should choose your tax return for an audit, there are several areas they are likely to scrutinize because taxpayers usually don't have the proper records to substantiate these deductions. The IRS agent can then make an easy adjustment, assess additional taxes, and close the case.

The purpose of this section is to alert you to some areas that are often audited and inform you as to what documentation is required by the IRS. It is easier to take a few seconds at the time of the transaction to make the necessary notes and keep the receipts than to try and substantiate your deductions the night before the audit.

Enclosed are discussions on the following areas 1) travel and entertainment expenses; 2) auto expenses; 3) insurance premiums; and 4) worker classification.

### **Travel and Entertainment Expenses**

The costs of business travel and entertainment (T&E) expenses are susceptible to IRS scrutiny because such expenditures may reflect personal as well as business objectives. Therefore, there are many requirements to be met in order to deduct these expenses. The following is an overview to those rules.

1. Only 50% of the cost of business meals and entertainment is deductible.
2. An employee's meals/entertainment deductions must be aggregated with "miscellaneous deductions."
3. The "quiet business meal" is no longer deductible.
4. No deduction is allowed for food and beverages, which are "lavish or extravagant under the circumstances."
5. The taxpayer must be present when food or beverages are furnished.
6. Travel for investment purposes or for education cannot be deducted.

### **T&E Record keeping Requirements**

Detailed record keeping is a must for travel and entertainment deductions. No deduction is allowed for any T&E item, which is not substantiated by adequate records. An "adequate record" is a contemporaneous diary, account book, log, expense statement or similar record. Additionally, in the following cases documentary evidence (e.g., receipts, paid bills, cancelled checks) must also be furnished: all expenditures for lodging while away from home and any other expenditure of \$25 or more. You don't need receipts for local transportation (e.g., taxis) where such receipts aren't readily available. Minor incidental expenses, such as tips, may be approximated (but must be entered in your diary or log). Documentary evidence may be adequate by itself; a diary or log entry may not be necessary, if the document discloses the amount, date, place and character of the expenditure.

In addition to these general record-keeping requirements, specific rules apply to 1) travel, 2) entertainment, and 3) business gifts.

- 1) Travel costs: The taxpayer must prove, via diary, receipts, etc., all of the following:
  - a) The amount of each separate expenditure for traveling away from home;
  - b) The dates of the departure and return home for each trip, and the number of days spent on business away from home;
  - c) The destination or locality of the travel; and
  - d) The business reason for the travel or the nature of the business benefit derived or expected to be derived as a result of the travel.
  
- 2) Business entertainment expenses: The taxpayer must prove all of the following:
  - a) The amount of each separate expenditure for entertaining, except that incidental items like cab fares and telephone calls may be aggregated on a separate basis;
  - b) The date the entertainment took place;
  - c) The name, address or location, and the type of entertainment;
  - d) The reason for entertaining, or the nature of the business benefit derived or expected to be derived as a result of entertaining, and the nature of any business discussion or activity that took place; and
  - e) The occupation or other information relative to the person or persons entertained, including name, title or other designation, sufficient to establish his business relationship to the taxpayer.
  
- 3) Business gifts: The taxpayer must prove all of the following:
  - a) Cost;
  - b) When the gift was made;
  - c) The reason for making the gift or the nature of business benefit derived or expected to be derived as a result of the gift;
  - d) Occupation or other information about the person receiving the gift, including his name, title, or other designation sufficient to establish his business relationship to the taxpayer; and
  - e) Description of the gift.

## Travel Away from Home

Expenses incurred while traveling away from home for business purposes are deductible.

Deductible travel expenses include meals and lodging enroute and at the destination, baggage charges, air, rail and bus fare, cost of transporting sample cases or display materials, expenses for sample rooms, costs of maintaining or operating a car, telephone and telegraph expenses, laundry and dry cleaning costs, cost of a public stenographer, cost of transportation by taxi, etc., from the airport or station to the hotel, from the hotel to the airport or station, from one customer or place of work to another, transportation from where meals and lodging are obtained to the temporary work assignment, and reasonable tips incident to any of these expenses.

### Mixed business and pleasure trips

Transportation costs to and from your destination are deductible only if the trip is related primarily to the taxpayer's business. If the trip is primarily for business, but the taxpayer extends his stay for personal reasons, makes side trips, or engages in other non-business activities, he may deduct only the expenses, such as meals and lodging, that he would have incurred if the trip had been totally for business, but no allocation is required for transportation costs to and from the business destination.

Foreign travel: Only the amount directly allocable to business is deductible in the case of a mixed purpose foreign trip. Even where the travel is primarily for business, a portion of transportation, meals, and lodgings, etc., expenses of the business part (as well as all the pleasure part) is nondeductible. The nondeductible part is computed on a time ratio, usually in the proportion of non-business days to all travel days.

This allocation and denial of deduction is not made if 1) the taxpayer, if an employee, isn't related to his employer and isn't a managing executive; 2) travel is for one week or less; 3) less than 25% of the time is spent in non-business activity; 4) the individual traveling had no substantial control over the arranging of the trip; or 5) a personal vacation was not a major consideration in making the trip.

Education, investment travel: The costs of travel as a form of education are not deductible, nor are the expenses of traveling for investment (as opposed to business) purposes.

### Entertainment

Entertainment expenses are deductible if they are "ordinary and necessary" business expenses and strict substantiation requirements are met. But no deduction is allowed unless the taxpayer can show that the entertainment expenses are: 1) "directly related" to the active conduct of a trade or business, or 2) "associated" with the active conduct of a trade or business.

Taxpayers may entertain business associates or other persons with whom the taxpayer could reasonably expect to engage or deal in the active conduct of his trade or business. Examples of business associates are customers, suppliers, clients, employees, agents, partners, or professional advisors, whether established or prospective.

Entertainment expenses are deductible if they are "directly related" to the active conduct of the taxpayer's trade or business. This test is met if the entertainment is 1) involved in an active discussion aimed at getting immediate revenue, 2) occurred in a clear business setting such as a hospitality room or 3) the expenditure must be reported as compensation for services performed by an individual other than employee.

Entertainment expenses that do not meet the "directly related" test but that are "associated" with the active conduct of the taxpayer's business are deductible if the entertainment directly "precedes or follows" a substantial and bona fide business discussion.

Entertainment facilities: No deduction is allowed for any expense paid or incurred with respect to "an entertainment facility" used in conjunction with an activity that is of a type generally considered to constitute entertainment, amusement or recreation. A deduction is now specifically not allowed in the case of social, athletic, sporting and other clubs dues even when the taxpayer establishes that the facility was used primarily to further the taxpayer's business and that the item was directly related to the active conduct of that business.

Expenses incurred with regard to entertainment facilities that are disallowed include yachts; hunting lodges, fishing camps, swimming pools, tennis courts, and bowling alleys. Fees paid to any social, athletic, or sporting club or organization is treated as expenditure for an entertainment facility.

### Business gifts

The cost of ordinary and necessary business gifts may be deducted up to \$25 a year to any individual.

### **Automobile Expenses**

The owner of a small business often uses a car or truck for both business and personal purposes. The extent to which the company can claim depreciation deductions, any investment tax credit, or lease payments depends on the extent to which the owner (or other employee) uses car or truck for business purposes. In addition, the value of a closely held corporations stockholder's personal use of a corporate-owned car or truck is a taxable fringe benefit.

### Luxury Car and Listed Property Limitations

The definition of a "luxury automobile" is a passenger automobile or light truck with an unloaded gross weight of 6,000 lbs or less.

If a car or truck is placed in service after December 31, 1986, its cost must be recovered over at least five years using 200% declining balance depreciation with a switch to straight-line. The luxury car limitations place a special dollar limit on the depreciation and Section 179 deduction you can claim each year. Although the dollar amounts change, as an illustration, for a car placed into service in 1992, your total Section 179 and depreciation deduction in the first year cannot exceed \$2,760; the second year cannot exceed \$4,400; \$2,650 the third year, and \$1,575 each later year.

Listed property includes any passenger automobile; other transportation vehicles, e.g. boats; computers and related equipment, and cellular telephone equipment. If your listed property is not used more than 50% for business during any tax year, Section 179 deductions are not allowed and you must depreciate the property using the ADS method.

### Percentage of Business Use

To the extent that business use of the automobile ("luxury" or otherwise) is less than 100% the allowable tax benefits and depreciation deductions must be reduced proportionately.

The Conference Committee Report on the Tax Reform Act of 1984 emphasizes that commuting is not considered to be business use of an automobile, even if business is conducted in transit. So, the Conference Report asserts, making or receiving phone calls on a mobile car telephone or holding a meeting in the car does not transform personal commuting into a business trip. Also, the fact that business advertising or promotional material is displayed on the car is not enough to make a Sunday drive in the country a business trip.

### Mileage Logs and Other Substantiation

An automobile-related deduction for depreciation, lease payments or other expenses must be substantiated by adequate corroborative records that evidence the extent to which the vehicle has been driven for business purposes.

The rule requiring adequate substantiation extends to "listed property" which includes passenger cars; other transportation vehicles; computer equipment; and property used for entertainment, recreation, or amusement. However, certain vehicles, which by their nature cannot be or are not normally used for personal driving, are excepted from the substantiation requirement. These include, for example, marked police cars; ambulances; and certain categories of trucks, construction equipment, and farm vehicles. There are four essential elements of an auto-related expenditure that must be substantiated.

1. Amount. This is the cost of the car, the amount of lease payments, all expenses for maintenance or repairs, and operation of the vehicle.
2. Time. This is the date that the expenditure was incurred or the car is used.
3. Business Purpose. The business purpose of the use or expenditure must be indicated.
4. Business Use. For an automobile, business use is determined according to mileage (for other listed assets, the basis for determining business use is time of use). It is also necessary to keep track of total use so that a percentage of business use can be

determined. In this regard, an odometer reading at the beginning and at the end of the year should suffice.

Adequate records of business driving can be maintained in the form of an account book, diaries, logs, statements of expenses, or trip sheets.

Documentary evidence, receipts and paid bills should augment such records. However, it is not necessary to enter information in an account book or diary if it is already indicated on a bill or receipt, as long as the record and receipt "complement each other in an orderly manner."

An entry in the account book or diary should be made at or near the time of the auto-related expenditure or use. As indicated previously, "business purpose " is one of the essential elements that must be substantiated. However, if a business purpose is evident from the surrounding circumstances, a written explanation of the trip's business purpose is not required. Also, the degree of detail necessary to demonstrate "business use" may vary. Less information is needed if the vehicle is driven according to a regular pattern; more is required if business driving is sporadic.

### Tax Return Reporting

A business claiming car and light truck related deductions must, on its tax return, provide certain information about the use of the vehicle. This information pertains to mileage (total, business, commuting, and other personal mileage), the percentage of business use, the date the vehicle was placed in service, and the existence of adequate records to support the business use being claimed on the return.

A business that provides more than five vehicles to its employees does not have to provide detailed information on its tax return. However, it must obtain relevant information from its employees and indicate that such data are in its possession.

A company that treats all use of company cars as personal use must indicate that on its tax return.

Use of a company car for business purposes qualifies as a working condition fringe benefit, and the value of that business-related use is not included in income. But to the extent the car is driven for non-business purposes, the value of such personal use is taxable (unless the employee reimburses the company for value of that use). IRS sets forth several alternative ways of arriving at the taxable personal-use value of a company car.

Hypothetical Lease. The first valuation alternative is the "hypothetical lease." What would it cost a hypothetical person to lease, insure, and maintain the same or comparable car on the same or comparable terms in the geographic area in which the car is used?

Annual Lease Value. The second method of valuing a company car is "annual lease value" as determined through the use of a table provided by IRS.

Commuting Rules. This is a special rule that may be used in valuing the personal use of a company car by certain employees when that personal use is limited solely to commuting. If certain conditions are satisfied, use of the car for commuting is valued at \$1.50 each way, or \$3.00 for each round trip commute by the employee. Also, a record of business driving need not be kept. This special computation can be used if:

1. The car is leased or owned by the company and it is provided to one or more employees for use in connection with company business,
2. There is a business reason for requiring the employee to commute to or from work in the car,
3. The company has written policy under which the employee (or a member of his or her family) is precluded from driving the car for personal purposes other than commuting (or some relatively minor use such as an errand on the way home from work),
4. The car is, in fact, not used for many other person driving, and
5. The employee who is required to use the company car is not what IRS refers to as a "control employee". (A "control employee" is a company officer, a director, or an employee who owns 1% or more of the business.)

Cents-per-mile method. In certain circumstances, it is permissible to value the personal use of a company car on a cents-per-mile method may be used if

1. During the year, the car is driven at least 10,000 miles by the employee; and
2. The fair market value of the car, on the date it is made available or January 1, 1985 (whichever is later), does not exceed the luxury car limits on cost recovery deductions in effect for that year.

## Withholding Requirements

Generally, taxes must be withheld from the income attributable to personal use of a company car or some other taxable fringe benefit. Tax can be withheld each pay period or on a quarterly, semi-annual, or annual basis, regardless of when the employee actually receives the benefit.

However, an employer can choose not to withhold income tax attributable to the personal use of an automobile (any applicable Social Security tax must still be withheld). This election need not be made for all employees who are furnished with company cars.

The value of an employee's personal use of the car is still considered to be taxable income that must be reported on the employee's Form W-2. The company can assume that all use of the car by the employee was personal use and report 100% of the car's annual lease value as income. The employee can calculate the value of any business use on Form 2106, Employee Business Expenses, and report the resulting amount on his or her personal tax return.

## Worksheet for Computing Additional Compensation

### Resulting from Personal Use of a Company Automobile

Employee's Name Employee's Social Security Number

The following must be answered by the employee:

1. Total miles driven during the year
2. Personal use miles (including commuting)
3. Percentage of personal use: #2 divided by #1
4. Is vehicle used for commuting? If yes, what is daily commuting mileage?
5. Is the vehicle available for personal use in off duty hours? If no, what is the number of commuting days?
6. Do records or evidence exist to justify the business deduction? If yes, is the evidence written? yes/no
7. What is the fair market value of the automobile? \$

The following must be completed by employer:

COMPUTATION OF ADDITIONAL COMPENSATION (check applicable method)

Hypothetical Lease Method-available to any employee. Burden of proof rests with taxpayer.

A) Cost to rent comparable auto	
B) Insurance	
C) Maintenance	
D) Fuel	
E) Total cost (Add A, B, C, D)	
F) Personal use percentage	
Additional Compensation (E x F)	

2. Annual Lease Value-method available to any employee. Utilizes annual lease table. Fair market value of auto \$

$$\begin{array}{l}
 \$ \underline{\hspace{2cm}} \quad \times \quad \underline{\hspace{2cm}} \quad \times \quad 1/12 \quad \times \quad \underline{\hspace{2cm}} \quad = \\
 \underline{\hspace{2cm}}
 \end{array}$$

Annual lease value Business months in use Personal Use % (A)

$$\begin{array}{l}
 \underline{\hspace{2cm}} \quad \times \quad 5.5 \text{ cents} \quad = \quad \underline{\hspace{2cm}} \quad + \quad \underline{\hspace{2cm}} \quad = \quad \$ \\
 \underline{\hspace{2cm}}
 \end{array}$$

Personal miles (B) (A) Additional Compensation

3. Commuter Method-written policy by employer that only personal use of auto is commuting to and from work. This method is not available for officer or an owner of 1% or more.

\_\_\_\_\_ x \$3.00 = \_\_\_\_\_

Days commuting to work Additional compensation

4. Cents-Per-Mile Method-only available if the following statements are all checked correct.

Vehicle is regularly used in trade or business throughout the year.

Total business and personal miles driven at least 10,000 per year.

Vehicle is primarily used by employee (not family members).

Fair market value of auto does not exceed luxury auto depreciation limit.

Personal miles \_\_\_\_\_ x 21 cents = \$ \_\_\_\_\_ of Additional Compensation.

**SUMMARY**

Additional compensation to include on employee's W-2 Statement is \$\_\_\_\_\_.

Additional Social Security needed to be withheld from employee salary is:

\_\_\_\_\_ x \_\_\_\_\_ = \$ \_\_\_\_\_

Additional Compensation Social Security rate

**Insurance Premiums**

Insurance premiums are ordinarily deductible in the tax year to which they apply. If you make an advance payment of the premium for an insurance policy that covers more than one tax year, even a cash basis taxpayer must prorate the premium and only deduct that amount which applies to the current tax year. The balance may be deducted in any later tax year to which it applies.

Generally, you may deduct insurance premiums paid on business insurance policies. Medical insurance paid by a proprietor and life insurance premiums require additional consideration.

The following are some of the more common deductible insurance premiums:

1. fire, theft, flood or casualty;
2. merchandise and inventory;
3. credit insurance to cover losses from unpaid debts;
4. employee's group hospitalization and medical; and
5. employer's liability;
6. property and liability;

7. workers' compensation;
8. use and occupancy and business interruption;
9. overhead; and
10. performance bonds.

Life Insurance premiums are not deductible if you are directly or indirectly a beneficiary of the policy. The following is a discussion of different types of policies and the deductibility of the premium.

Credit Life Insurance - life insurance purchased to get or protect a business loan is not deductible.

Key-person Insurance - life insurance covering any officer, employee or other financially interested party is deductible only if: 1) the payment is in the nature of additional compensation, 2) the total amount of compensation is reasonable, and 3) the policy is not beneficial to you either directly or indirectly. Key-person insurance are wages subject to withholding.

Split-dollar Insurance - if the officers or employees designate their own beneficiary, the employer retains no incidents of ownership and is not directly or indirectly the beneficiary, then the premiums are deductible. If more than \$50,000 of insurance is purchased, the officer or employee may have to include as income the premium on the excess amount.

Until 1987, the medical insurance premiums paid by a self-employed person were only deductible as an itemized deduction on his personal tax return. The TRA of '86 permits a deduction of part of the premiums paid in calculating his adjusted gross income; the amount does not reduce the net earnings from self-employment for the self-employment tax computation.

Certain insurance premiums that are not deductible include any self-insurance premiums, or any premium paid on a policy that pays you for your lost earnings due to sickness or disability. This is not to be confused with overhead or business interruption insurance, which are deductible.