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By Samuel Greengard

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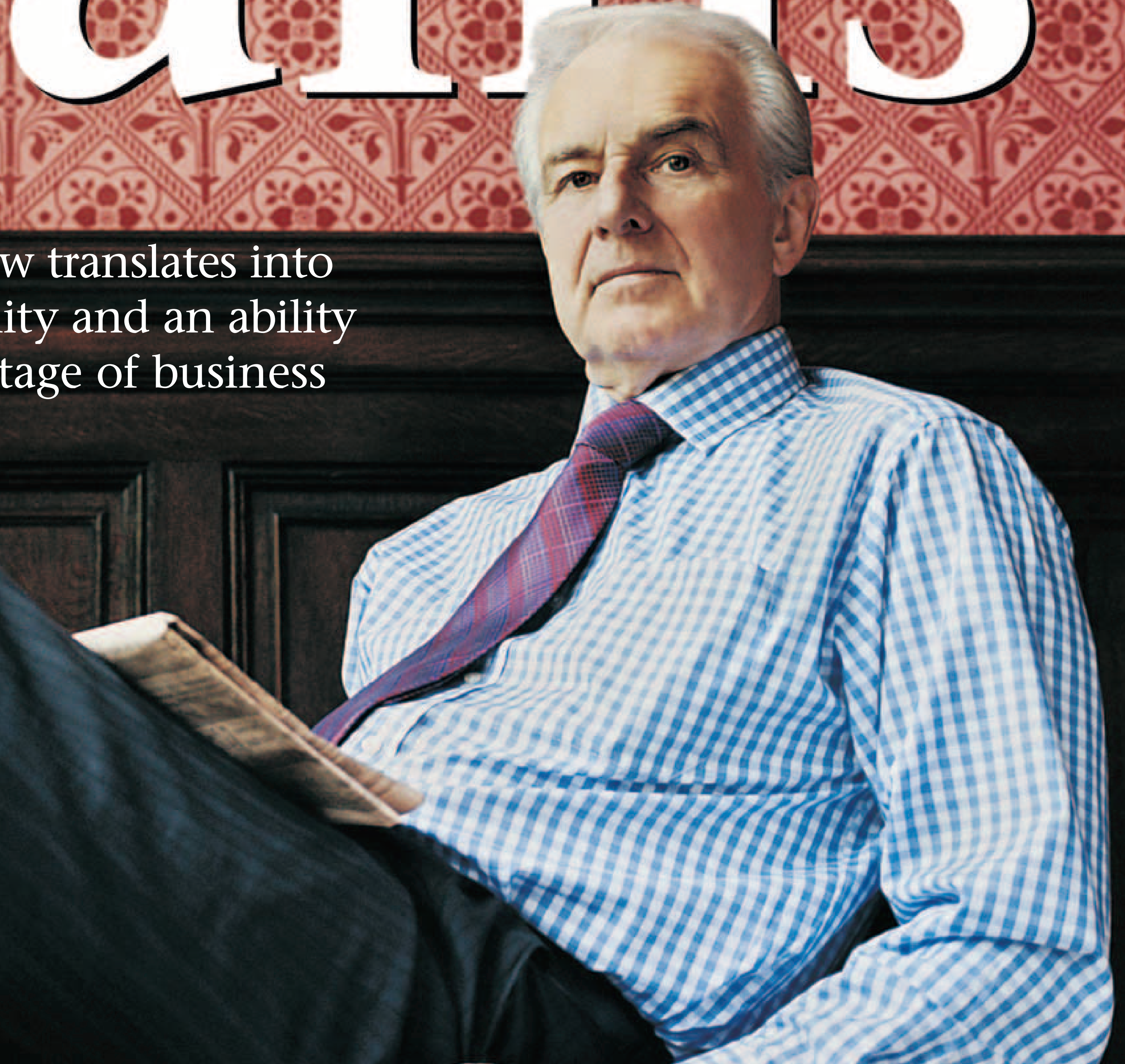

"Effective money can help a compa

Great ideas and a well-executed strategy can take a company only so far. Behind the visible artifacts of a business—products, business processes and management structure—lies the task of managing working capital and minimizing taxes. "It's one of the most crucial and neglected elements of running a small business," says Nicholas J. Crocetti, a director at CBIZ Inc., an accounting and tax advisory firm based in Plymouth Meeting, Pa. "The decisions a business owner makes have a profound effect on profitability and success."

To be sure, maximizing working capital and minimizing taxes can pay enormous dividends. Not only can a firm save money and increase its profitability, better cash flow translates into greater flexibility and an ability to take advantage of growth opportunities.

"Effective money management and tax planning can help a company achieve a distinct advantage," says Julie A. Welch, director of tax services at Meara, King and Co., a Kansas City, Mo., accounting firm.

Money Matters

Up-front planning can go a long way toward maximizing financial opportunities, and for a new business one of the most important factors is deciding where to set up shop. State and local tax rates vary greatly and can impact a small business in a big way. Some states and cities offer significant tax breaks to start-ups. These incentives can reach hundreds of thousands of dollars or more. At the same time, existing companies can sometimes benefit by relocating to a place that offers a more favorable tax environment or other incentives.

The type of business entity that's created also can have a profound effect on taxes and working capital. Although such a decision should be based on business goals and objectives—and legal liability is often a primary factor in determining whether to establish a limited-liability corporation (LLC), S-Corp or other entity—flow-through taxation can result in significant bottom-line savings, Crocetti says. For example, $1,000 of earnings taxed at a 35 percent federal corporate rate would result in $650. If the remaining sum is paid out as a dividend on a personal return, it would also be subjected to taxes. But with a flow-through entity in place, the earnings would be taxed once, rather than twice.

Another key factor to maximize cash flow is the type of accounting method that's used. Although many individuals and small companies rely on a cash-based accounting process that records transactions on the date cash flows in or out of the business, an accrual method (which records the transaction when it occurs rather than when the seller col-

management and tax planning
ny achieve a distinct advantage."

lects the cash) or a long-term contract method of accounting (when a project spans multiple years) can provide benefits. For instance, the latter approach would allow a small homebuilder to avoid recognizing expenses and revenues based on a percentage of project completion and defer tax liability until project completion. This technique maximizes cash flow and provides additional working capital.

Likewise, a business owner can opt for either a First In, First Out (FIFO) or Last In, First Out (LIFO) method of accounting. The latter approach defers taxes by allowing a business to declare recently purchased, higher value inventory in place of older, lower priced inventory. This approach—which reduces current income—can boost the bottom line, particularly during a period of rising prices, Crocetti says. The downside is that during a period when the price of goods and inventory decline, LIFO can boost tax liability.

Finally, there's the issue of whether to adopt a traditional calendar-based accounting period or use a fiscal-year method. While a calendar year offers maximum simplicity, a fiscal year can further defer taxes on a one-time basis. This can prove particularly valuable for a second business start-up with limited capital. For instance, a manufacturing firm that opens its doors in January but reaches its break-even point in July might select a July 30 fiscal year closing. That way, it will incur zero tax liability for the first fiscal year and pay the taxes after the second fiscal year. Similarly, a business owner might declare a Sept. 30 closing for a firm but not draw a salary until January. This would defer personal income taxes a full year because they're based on a calendar year.

In some situations, it's wise to combine approaches, including entity selection, accounting method and the choice of a fiscal year to achieve additional gains, Crocetti says. And second business start-ups aren't the only companies that can benefit from this approach. Established businesses sometimes create new business entities or an accounting method for a particular division or a product so they can balance working capital and cash flow. A business might also make a one-time switch to a different accounting method or fiscal year, he adds.

Alternatives to Boost Capital

1. Small businesses can use other strategies to slash taxes and boost working capital. One of the most effective approaches is expensing items under Section 179 of the federal tax code. It offers a $108,000 limit for 2006. By doing so, it's possible to receive the entire tax deduction for equipment and supplies in a single year rather than depreciating the items over several years, says Rick Thompson, CPA, a tax partner at Sikich Group in Aurora, Ill.

2. Leasing also can provide benefits in certain situations, says Sheryl Rowling, CPA, PFS, a managing partner at Rowling, Dold & Associates LLP, a San Diego-based accounting firm. For one thing, it can free cash for other purchases by reducing the down payment and overall capital expense of an item. For another, it's possible to deduct the entire payment rather than only the interest paid on a loan. "In some instances, it can result in a significantly larger tax deduction," she says.

3. Finally, small businesses should consider funding a retirement account, such as a 401(k), SEP-IRA or qualified pension plan. Not only can it attract good employees and help business owners fund their retirement, but it also can provide substantial tax breaks and help a business maximize cash flow, Welch explains. What's more, it's possible to contribute the company's portion of the funds up until tax day and still receive the benefit for the previous year.

While there's no shortage of strategies for maximizing working capital and reducing taxes—and checking with an accountant or tax advisor is essential—it's clear that the smart money is in companies that maximize capital. In the end, these business owners find the situation a lot less taxing. ■

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