

When to use Cash Basis Tax Accounting in the Printing Industry

By Fred Bauer and John Boykas

As a print broker, you may avoid an audit and maximize your cash flow if you understand the benefits of cash basis accounting. The IRS has ruled that if you hold inventory, then by definition you must report income for tax purposes on an accrual basis. The key question is do you, as a print broker hold inventory? In this article we will show you how to reduce your tax burden through careful planning.

For those of you who are confused between cash basis and accrual basis accounting, let's see if we can simplify it. From a tax perspective, cash basis accounting allows you to declare income when cash is put in the bank, while accrual basis accounting forces you to declare income based on the shipping of a completed job. This has an impact on cash flow. Taxes paid on an accrual basis increase the amount of working capital required to meet your tax liability.

There is one small advantage to accrual accounting. When bills are received, they can be used to reduce your income, for tax purposes, regardless of when you pay them. While this somewhat mitigates the cash flow requirements, it typically does not offset the disadvantages. This is primarily because as a business owner, you can determine when bills are paid. If a business owner borrows money and pays his bills he can maximize his deductions and minimize his taxes.

As a print broker you may receive an order for 1000 flyers, which you then place with a bulk printer on December 26th, 2004. The printer ships the order the next day and it is received by the client on December 30th. If you never hold the inventory and bill the work on December 30th, 2004 then the income is subject to tax in 2005 on the cash basis, when paid by the customer. This allows you to keep the taxes in your pocket for an additional year.

If you hold inventory, however, then the income is subject to tax when you invoice the work at the time it is shipped. This means that you will have to pay the taxes a year earlier.

If you hold inventory for some work and broker the rest of your work, it may make sense for you to set up a separate print brokerage company that does only brokerage work. If this work is a significant piece of your billing for the year, you may be able to defer some of your tax liability into the subsequent year by using the cash basis of accounting for your print brokerage business.

It is important to remember that any holding of inventory impacts every transaction that a company does. If you have ever held inventory in the history of your business, then you are considered to be a business that must report their taxes on an accrual basis. Even if

you sell stock paper, you are considered to hold inventory. You are considered to hold inventory unless you can demonstrate that the paper is drop shipped from the manufacturer to the end user. Therefore, holding stock paper eliminates the ability to use the cash basis method for reporting income.

The IRS perceives that the printing industry always holds inventory. They don't distinguish between print brokers and print manufacturers. It is difficult to prove that you don't hold inventory, and the IRS may request a physical inspection of your premises. Therefore, it is incumbent upon you to show that you don't.

If you are subject to an audit, your defense is to show that there is no inventory in your possession. In any audit, the IRS will also look to see if you are paying rent on any other locations. You may also be required to show, on a test basis, that your orders were drop shipped from the plants directly to your customers.

This discussion has focused on tax based reporting. From a managerial accounting perspective, however, accrual accounting has significant advantages. Only with accrual accounting do you match your revenues and expenses. An accurate profit and loss statement done on an accrual will show you the true costs of your income, while cash accounting will show receipts coming in after you have paid for the inventory. This may distort your earnings based on the timing of your customer's payments.

If you have further questions on how to set up your books, please feel free to contact John. He will be able to tell you which accounting method is more appropriate for you.

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For more information on how to minimize your tax risk, please contact the authors.

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