 By Alan Friedman

Taxes for Music Retailers: The Good, the Bad and the Complicated

"FOR PURPOSES OF PARAGRAPH (3), an organization described in Paragraph (2) shall be deemed to include an organization described in section 501(c)(4), (5) or (6) which would be described in paragraph (2) if it were an organization described in section 501(c)(3)."

Say what??? This almost unintelligible section of our current Internal Revenue Code is just another byproduct of the 824 amendments, 285 new code sections, 114 changes in 1997, 69 changes that went into effect this year, 36 retroactive provisions and five changes, effective as long as 10 years later, enacted by the new Taxpayer Relief Act of 1997.

This new tax act is the largest and most significant tax legislation since the Federal Tax Reform Act of 1986. But despite recommendations by the IRS Restructuring Committee to simplify the tax code, this new legislation makes our tax code more complex than ever. That's why our office has affectionately renamed it "The Accountants' Job Security Act of 1997."

Still, it contains many long-awaited changes that will help many taxpayers, including individuals, families and closely held businesses. Accordingly, many music retailers will be able to take advantage of both the new tax relief provisions as well as time-tested year-end tax planning strategies, provided they have someone on their team who knows their business, their industry and how to decipher the extraterrestrial language of our Internal Revenue Code.

So let's highlight some of the new tax law changes and discuss a few of the more pertinent tax-saving strategies that most music retailers can benefit from this year. I'll try to speak a language that resembles English to keep you awake along the way.

Lower Capital Gains Rates

The new law slashed the top long-term capital-gains rate by nearly a third (from 28 percent to 20 percent, and to 10 percent for taxpayers in the 15-percent tax bracket). This favorable rate change will lower taxes paid by owners of sole proprietorships, partnerships, limited liability companies and "S" corporations (as these entities "pass through" a store's taxable income and capital gains to its owners). To benefit from the lower capital gain rate, a capital asset (such as a company vehicle) that's sold must have been held for at least 12 months and sold after July 29, 1997.

Retirement Plan Changes

It's now easier for entrepreneurs to maintain company retirement plans, such as 401(k) plans and Individual Retirement Accounts (IRA), since Congress raised the income ceiling on deductible IRAs. New this year, the law increases the income levels at which a couple

with a non-employed spouse can fully contribute to an IRA (from $40,000 to $150,000 of adjusted gross income), and the IRA amount that can be contributed (from $250 to $4,000).

As an added sweetener, Congress created the Roth IRA, named after its chief proponent (no, not David Lee Roth), Sen. William Roth, chairman of the Senate Finance Committee. Starting this year, married individuals with adjusted gross incomes of up to $150,000 ($95,000 for single people) can each make a $2,000 contribution to their Roth IRA. Though the contributions are nondeductible, they grow tax-free and proceeds can be withdrawn tax-free after five years when you reach age 59½, become disabled or become a first-time home buyer.

Accelerated Depreciation on Rent-to-Own Assets

The new Taxpayer Relief Act provides for an accelerated write-off of any consumer property subject to a "rent-to-own" (RTO) contract. Accordingly, any music retailer renting band and orchestra instruments under a RTO contract can now depreciate the rental instrument over a three-year period. But beware, the retailer must comply with the rules of IRS Rev. Proc. 95-38 in order to avoid the RTO contract being treated as a sale (and taxed immediately), and to take advantage of the new quicker depreciation (see the February/March '98 Music Inc. *Think Tank* article on "Accounting Basics for Rental Revenue").

Labor Incentives

You can slash thousands of dollars off your tax bill by hiring welfare recipients. This move is too good to ignore. The new tax law offers business owners a generous welfare-to-work credit. Your company can save $8,500 in taxes over a two-year period for each welfare recipient hired after Dec. 31, 1997 and before May 1, 1999. You can get more information on this and other job programs by calling the Welfare-to-Work Partnership located in Washington, D.C., at 888-USA-JOB1 (872-5621).

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Less Tax on Estate Assets

Like it or not, with the increased presence of large music superstores, mail-order houses and internet commerce, many small music retailers are thinking about retirement. That, coupled with the new tax law's increase in estate-tax exemption for small businesses, makes it a good time to re-think how you intend to leave your business legacy to your family, partners or employees.

The old federal rate for estate taxes (also known as "death taxes") began at 37 percent for amounts over $600,000, and hit 55 percent for estates passing the $3 million mark. From 1998 to 2006, the new law gradually increases the estate-tax exemption from $600,000 to $1 million.

More significant to small business is that owners of family-run companies can get an even bigger tax cut. Your estate-tax exemption jumps to $1.3 million if the value of your business exceeds 50 percent of your total estate worth, and if you've been active in the business for five of the eight years before your death. But your heirs must continue to manage the affairs of your company for 10 years. If an heir calls it quits sooner, the IRS can come back and impose additional estate taxes. The amount of taxes that heirs would owe will depend on the number of years they ran the business. Uggghhhh... all these rules and exceptions!!!

1998 Year-End Tax Tips

There's a very strange phenomenon that frequently occurs at the end of your fiscal year—you owe taxes on your store's net profits,

but you have no cash!!! That's usually because the store's earnings are tied up in inventory. So here's five neat ways to minimize or even eliminate taxes arising from your music store's fiscal year profits:

(1) Accelerate deductions. There's no better way to show the IRS who's boss than by seizing control of your checkbook. If store supplies are low, make last-minute purchases and get those deductions by Dec. 31. Schedule needed repairs and maintenance, pay employee bonuses, take necessary business trips, throw holiday parties and make charitable contributions prior to the year end. But don't be misled into buying more inventory, as you're just trading one asset (cash) for another (inventory). And don't think you have to deplete your cash by year's end to get deductions, as you should be on the accrual basis of accounting, which allows you to take deductions for expenses as they're incurred, not paid.

(2) Keep income at bay. If you want to keep taxes low, shift income to 1999. For example, take a deposit on a piano or sound system the last week of December, then deliver and bill it the first week in January. The customer deposit secures the sale, yet isn't counted as income until you deliver the goods. This is a great idea, especially if you think your tax bracket will be lower in 1999 than 1998.

(3) Pester delinquent debtors. If your store is looking for more write-offs, review your accounts receivable for possible bad debts that can be written off.

If you make a good-faith effort to collect these debts, the IRS will then allow you to take a write-off deduction as a bad debt expense. But don't lose sight of your mission: it's to collect the money, not get a tax deduction. The tax deduction is the loser's consolation prize.

(4) Write down old or obsolete inventory. Review your inventory for old or obsolete goods that have fallen in value below their initial cost. Under the "lower of cost or market" inventory valuation method, you're allowed a "write-down" or devaluation of your inventory. For example, if you bought a synthesizer last year for $700 (that was supposed to sell for $1,200) and its current market value is $400, you can immediately take a $300 write-down deduction on that item.

(5) Give yourself a benefit plan. Depending on your company's tax type, you can turn non-deductible personal expenses (medical bills, day-care costs and others) into legitimate business deductions by establishing an employee-benefit plan. For example, set up a medical reimbursement plan. This employer-sponsored plan covers medical costs that are not usually included in health insurance policies (such as dental expenses or prescriptions), up to a maximum of $5,000 a year, per employee.

Some Final Thoughts

One of the healthiest and most important year-end strategies is to sell off slow-moving inventory. By doing so, you increase inventory turns and lighten the cost burden of carrying inventory. If you have to sell items at a loss, you'll at least get a tax deduction through cost of goods sold, and have the cash to reinvest in profitable goods. And if you sell items at a profit, you'll generate more cash than the tax burden created by the sales revenue. Either way, you win.

Although we all want to pay fewer taxes, don't shortchange yourself by taking aggressive (audit-provoking) tax positions and cheapening the credit worthiness of your financial statements to your banker and suppliers.

Most importantly, get your CPA firm to assist you BEFORE the end of your fiscal year, as there's not much that can be done to minimize taxes after your tax year has ended. This way, the only thing that stays ugly is your accountant, not your tax bill.

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