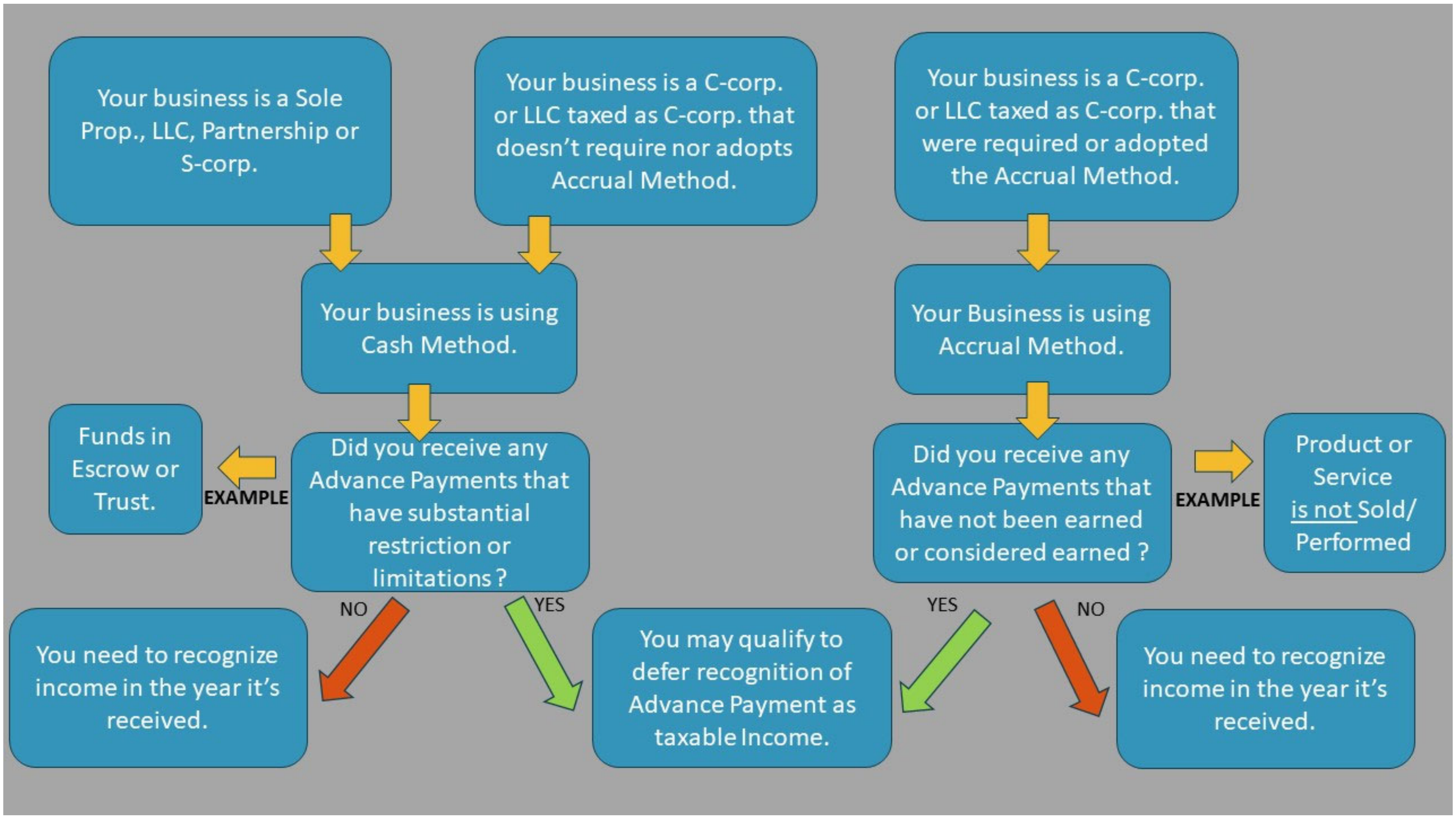
Income Recognition Rules for Small Business

This presentation has been prepared using general concepts and simplified tax rules; it is essential to seek further consultation with a tax professional.



Reducing the amount of taxes, you owe is an important part of managing your finances effectively. One way to do this is by postponing qualified customer payments into future years. However, it's crucial to know that this approach doesn't work the same for every business. Your specific business structure and situation makes a pivotal difference in the effectiveness of this strategy.

To help you understand how this works, I've prepared a chart that shows you how to determine your Method of Accounting and which deposits might qualify. I've also added extra information on page 2 explaining some rules and concepts surrounding Methods of Accounting and Income Recognition.

For more information here is a link to [IRS Publication 538.](#) (Accounting Methods starts on Page 7).

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Methods of Accounting.

Before delving into the concept of Income Recognition, it's essential to distinguish between the Cash and the Accrual Methods of Accounting. These methods determine when a business recognizes and reports income on the tax returns. In simple terms, under the Cash method business reports income when income is **received** (direct deposit, check, cash etc.) and under the Accrual it reports income when income is **earned** (product is sold, service is performed).

Cash Method, "the Cash".

Most small businesses such as Sole Prop., LLC, Partnership, S-corp. are **required** to report income using the Cash on their tax return, so in the year income is *received it must be reported* by the business. Consequently, any *Advance Payments* received by the business, under the Cash, are considered income, regardless of whether they are earned.

There is an exception to the general income recognition rule. If income received is subject to "substantial **restrictions or limitations."**

From a practical standpoint, businesses that establish an escrow or trust accounts will not recognize income for funds that were deposited and remained undistributed by the year-end. Furthermore, before transfer from escrow, clients need to be notified with invoices for the transfer amount. This structure is commonly used by legal firms and construction industries.

The greatest benefit under the Cash for the business *is not including Receivables* as taxable income for the year.

Accrual Method, "the Accrual".

The Accrual is typically utilized by larger businesses, structured as subchapter C corporations. The IRS requirement to adopt the Accrual is $26 million over the last 3 years, however a business structured as C-corp. can *voluntarily adopt* the Accrual if beneficial for the business.

Under the Accrual, business *reports income when income is earned*, so business *will include Receivable as taxable income*.

The Advance Payments received for goods and services could be deferred or included in income. If a business chooses to defer the advance payments those payments must be recognized as income in the **next year**. The business also makes an adjustment for any portion of the Advance Payment that's considered earned, to include that portion in its income. The business that chooses the deferral method will stay on it unless a filing request is sent to IRS to change the treatment of advance payments.

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