DOCUMENT RESUME

ED 059 475 AC 012 356

TITLE	Taxation; A Key Factor in Business Decisions.
INSTITUTION	Small Business Administration, Washington, D.C.
REPORT NO	Topic-8
PUB DATE	66
NOTE	87p.
AVAILABLE FROM	Superintendent of Documents, U.S. Government Printing Office, Washington, D. C. 20402 ($1.25); Small Business Administration, Washington, D. C. 20416 (on loan basis)
EDRS PRICE	MF-$0.65 HC-$3.29
DESCRIPTORS	*Administrative Personnel; Audiovisual Aids; Bibliographies; Business Administration; Case Studies (Education); Course Content; Distributive Education; Instructional Materials; Lecture; Lesson Plans; *Management Education; Manuals; Participant Characteristics; *Professional Continuing Education; *Taxes; *Teaching Guides; University Extension

ABSTRACT

To aid in teaching management of financial matters to the small business man, this publication contains material for a 45- to 60- minute lecture, which is usually followed by a discussion period. The booklet contains the following sections: (1) The Lesson Plan--an outline of the material covered, presented in two columns: an outline of the presentation, and a step-by-step indication of procedure; (2) The Presentation--a subject presentation: (3) The Visual Aids--a set of photographic copies of the visual aids available for this topic; (4) The Supply Department--materials that may be reproduced locally for distribution to course participants; (5) Cases in Point--short actual small-business management cases that may be used to augment the presentation and develop discussion, or as the basis for a second session; and (6) The Incubator--ideas for stimulating further thought and discussion by the participants. A short bibliography is provided, and field officers of the Small Business Admini stration are listed. (DB)

F-X

TAXATION:

A KEY FACTOR IN BUSINESS DECISIONS

ADMINISTRATIVE MANAGEMENT COURSE PROGRAM

Topic 8

SMALL BUSINESS ADMINISTRATION

ADMINISTRATIVE MANAGEMENT COURSE PROGRAM

Topic 8

Small Business Administration

Washington, D.C. 20416 1966

SMALL BUSINESS ADMINISTRATION

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Washington, D.C., 20402 - Price $1.25

FOREWORD

The Administrative Management Course Program was developed by the Small Business Administration in cooperation with educational institutions to bring modern management knowledge and techniques to the owners and managers of small businesses. In 12 years over 1,000 universities, colleges, and local school systems have cosponsored over 4,300 courses with this Agency. Over 110,000 owners and managers of small businesses have attended these courses. Distributive Education, working through the local school systems, has accounted for about one-third of these totals.

This is an outstanding demonstration of public spirit and service on the part of these hundreds of educational institutions. Yet, there remain many thousands of small-business owners and managers who have never had the opportunity to attend an administrative management course.

A committee on management education, consisting of representatives of the Small Business Administration and the Distributive Education Division of the American Vocational Association, was formed to study ways of meeting the small-business management needs of the small communities and very small businesses in poverty areas. The committee recommended that a series of subject presentations, including lesson plans, lectures, visual aids, case studies, and handout material, be developed to assist in the establishment of administrative management course programs in new locations. Further, it was felt that this material could substantially assist existing management programs, particularly by emphasizing the importance of continuing education for small-business owners and managers, and by assisting the busy instructor with his preparation.

SBA accepted the responsibility for developing a series of subject presentations in the field of administrative management for use by educators and businessmen who teach these management courses. We believe that these presentations will be particularly useful to Distributive Education in the smaller community where library research facilities are limited and equipment for the production of visual aids is not readily available. They will also assist community planning groups in implementing the educational provisions of the Economic Opportunity Act of 1964.

This booklet was prepared jointly by staff members of the Internal Revenue Service and SBA's Management Development and Training Program, under the administrative direction of George C. Willman, Jr., Program Manager. Artwork and visuals were prepared by the Graphics and Design Branch, Office of Administrative Services.

Bernard L. Boutin
Administrator

August 1966

CONTENTS

*A set of the visual aids is available from the nearest SBA regional office (see inside back cover for listing). These visuals are 8- by 10-inch colored transparencies for use on overhead projectors.

**Among the materials prepared as "handouts" to participants are several SBA free publications. Current information on the availability of suggested and new SBA publications may be obtained from the nearest SBA office.

A WORD ABOUT THIS SESSION

This publication, one of a series, is directed toward teaching management skills to the small-business man. When the term "management" is used, it refers to administrative management functions rather than to purely operational features of business. The complete set of subject presentations may be obtained on loan from the nearest Small Business Administration field office (listed on the inside back cover). Single booklets or complete sets may be purchased from the Superintendent of Documents, Washington, D.C. 20402.

This topic, Taxation: A Key Factor in Business Decisions, was prepared to aid in teaching one session of a basic course. It contains sufficient material for a 45- to 60-minute lecture which is usually followed by a discussion period. The management case on page 63 can be used to extend the session or to form the basis for a second session on the topic.

The lecture is designed to be presented to the businessman in nontechnical language. It is one approach to teaching management of financial matters. Instructors will probably prefer to modify or revise the lecture in order to use their personal background and experience in the subject area. They may also find it preferable to alter the topic to take account of the training or special needs of their class participants.

This topic may be handled by a tax lawyer, an accountant, an Internal Revenue Service officer, or another whose training, experience, and interest qualify him. Guide for Part-Time Instructors, Distributive Education for Adults, a publication of the U.S. Office of Education, may prove useful to local instructors.

The various sections of the publication are separated by divider sheets of different colors. On the following page, these colors are given and the contents of the sections are briefly described.

Gray -- The Lesson Plan. An outline of the material covered which may be used as a teaching guide, or as a framework for developing an individualized presentation. The lesson plan contains two columns: the left-hand column is an outline of the presentation; the right is a step-by-step indication of procedure, including chalk-board suggestions, quotations, discussion points, and a keyed guide to the visual aids supplied.

Rust -- The Presentation. A carefully prepared subject presentation which may be used as written or modified to meet local needs and conditions. It may also be used as a source of information by a person preparing his own lecture.

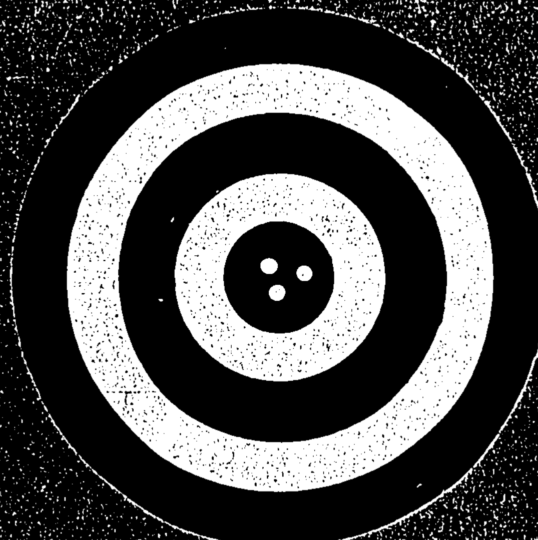
Buff -- The Visual Aids. Photographic copies of the set of visual aids which are available for this topic. These visuals are 8- by 10-inch colored transparencies prepared for use on overhead projectors. The subject presentation and lesson plan are keyed to the visuals. A set of visuals for each subject in this series may be borrowed from the nearest SBA regional office.

Green -- The Supply Department. Materials which may be reproduced locally for distribution to course participants. Your nearest SBA office can furnish information on current availability of SBA free publications, including titles published subsequent to this volume.

Yellow -- Cases in Point. Short actual small-business management cases which may be used to augment the presentation and to develop discussion, or as the basis for a second session on the same topic.

Blue -- The Incubator. Ideas for stimulating further thought and discussion by the participants. This material may be reproduced locally for distribution to course participants. "Assignments" are designed to aid in retention of the subject matter of the session.

Note: See back cover for index reference to the divider sheets.



THE LESSON PLAN

A Keeping on Target

Section

Good teaching depends on good planning. A session objective or target must be set. Then the points are selected that will enable one to keep hitting at the heart of that target.

The primary aim of the instructor is to first give the participant the things he MUST KNOW, then the things he SHOULD KNOW. When these two aims have been achieved, the topic can be embellished with the "nice to know" and helpful to know elements.

The following lesson plan is "on target." If it is used as a guide, it will enable the instructor to emphasize the major points while at the same time he stimulates the participants to grasp the subject.

STIMULATE GROUP BY SERVING AN INSTRUCTIONAL COCKTAIL

RECIPE

Use The Three B's (Bubbles)

- O ***Base*** instruction on problems at learners level.
- O ***Blend*** instruction with job experience.
- O ***Brighten*** instructions with variety of ***illustrations, investigations*** and group ***participation.***

FOUR BASIC STEPS OF INSTRUCTION

Instructing is like selling - -

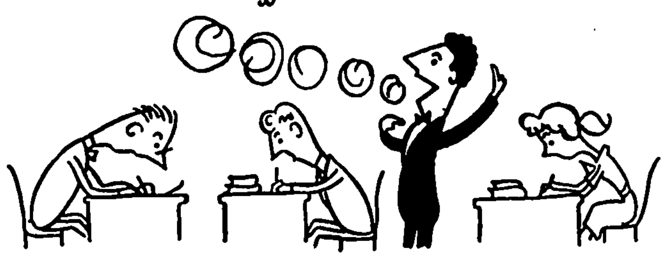
Selling

1. Approach customer
   - Promptness
   - Put at ease
   - Awaken ***interest***
2. Present merchandise or service
   - Select merchandise to fit need
   - Show one item at a time
   - Demonstrate ***selling points***
3. Have customer take part
   - Get merchandise into customer's hands
   - Let customer "try on" merchandise
   - Answer questions and meet objections
4. Bring sale to close
   - Help customers decide; ask: "which" "for whom" "when"
   - Be sure merchandise fits need
   - Summarize points of care and use
   - Handle mechanics of sale
   - Pave way for return visit

Instructing

1. Prepare the group
   - Start on schedule
   - Put group at ease
   - ***Awaken*** interest
2. Present information
   - Gauge material to needs
   - Present one point at a time
   - ***Show, illustrate, question***
3. Have group participate
   - Get group to ***discuss***
   - Have members ***demonstrate*** or ***use*** ideas
   - Answer questions and correct errors
4. Bring meeting to a close
   - Check on understanding; ask: "why" "how" "when" "what" "where" "who"
   - Be sure group now can use information
   - Summarize "take away" ideas
   - Make a definite conclusion
   - Pave way for next session

How To Deal With "Difficult Customers"



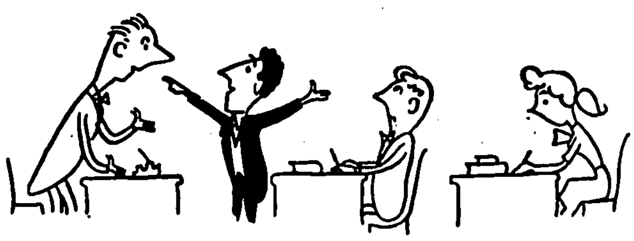
What To Do

THE "MOUTH"—wants to do all the talking.

Take the play away from him by asking others to comment on his remarks.

Deliberately turn to others and ask for their opinions. Avoid looking at him.

Tactfully ask him to give someone else a chance, or talk to him in private.



THE "ARGUER"—constantly tries to catch you up.

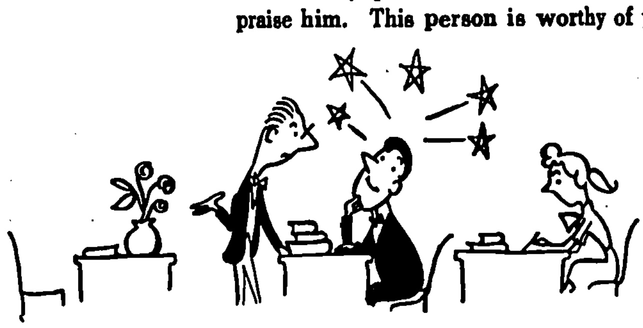
Keep cool. You can never "win" an argument. Always make him back it up. Ask for evidence.

Avoid getting personal.

Refer the question to the group and then to him.

THE "MOUSE"—is in every group.

Call him by name and ask him for an opinion. Ask him an easy question he is sure to answer well, then praise him. This person is worthy of your attention.



THE "SO-WHATER"—is disinterested.

Point up something he has done as a good example of the point being stressed. Ask direct questions affecting his work.

LESSON PLAN

TOPIC: TAXATION: A KEY FACTOR IN BUSINESS DECISIONS

OBJECTIVES:

To inform the businessman of his tax responsibilities.
To show the need for careful management decisions in tax matters.
To point out sources of tax aid and information.

SESSION CONTENT	TIPS AND APPROACHES
I. INTRODUCTION	Visual No. 1; use the Holmes quotation (or other appropriate introduction) to establish contemporary attitudes toward taxes.
A. Taxes supply revenue to-- 1. Pay for national defense 2. Support domestic programs 3. Meet commitments abroad	
B. Duty to pay--but only the amount required by law	Discuss the Hand quotation.
C. Knowledge of taxes important--	
1. Tax rate on incomes varies 2. Some business transactions taxed differently 3. Tax benefits sometimes missed	If time permits, give examples of these points.
D. Year-round tax counseling offered by IRS	Write on chalkboard: (1) the address of nearest IRS office; (2) title <u>Tax Guide for Small Business</u>. If possible, pass around a copy of the latest edition of this handbook.

II. MANAGEMENT AFFECTS TAXES

A. Business decisions and tax consequences

Form of business organization--corporation, partnership, single proprietorship--must be considered

Visual No. 2; time permitting, elaborate on ways that different types of business organizations are taxed.

B. Laws and management decisions

Distribute Handout No. 8-1; point out significance to businessmen of each act of legislation

1. Equity capital
2. Loss carryback
3. Revised depreciation rules
4. Investment tax credit
5. Voluntary pension plans
6. Reduction of income tax rates

C. You must decide

III. MAJOR FEDERAL TAXES

Visual No. 3. (Use this visual to open discussion of each of these three major groups.)

A. Income taxes and--

1. Forms of organization

   a. Corporation (dividends taxed at individual rates)
   b. Partnership
   c. Proprietorship

2. Decisions affecting taxes	
a. Business expenses Ordinary and necessary--including rent, utilities, supplies, salaries, insurance, advertising, licenses, commission, interest	Visual No. 4; use to introduce discussion of each type of deductible expense. Visual No. 5; stress that substantiating records must be kept and that amount deducted must be reasonable.
b. Travel and entertainment expenses	Visual No. 4. Discuss Revenue Act of 1962, and need for it, as shown by safari and debut party stories.
(1) Criteria for allowance	Visual No. 6.
(2) Wife's expenses--generally not deductible	If available, pass out copies of IRS Publication No. 463, <u>Rules for Deducting Travel, Entertainment, and Gift Expenses</u>.
c. Capital expenditures	Visual No. 4.
(1) Repairs, improvements, and additions	
(2) Can deduct regular maintenance, but not capital expenditure	Discuss, using example mentioned on p. 21, or other situation if more appropriate to local conditions.
(3) General rule: useful life more than 1 year, capitalize	

d. Depreciation	Visual No. 4.
(1) Property--deductible (2) Land--not deductible (3) Intangible assets--varies	IRS Publication No. 456, Depreciation Guidelines and Rules, will be helpful in preparing this section. Quiz participants on their understanding of the new criteria.
(4) Types of depreciation: (a) Straight-line (b) Declining balance (c) Sum of the years-digits	Visual No. 7; discuss each type, using formulas.
e. Investment credit	Visual No. 4.
(1) Purpose (2) Method	Discuss, using example on p. 23.
(3) To qualify (4) The carryback provision (5) Limitations	
f. Inventories	Visual No. 4.
(1) The 5 main types: merchandise or stock in trade, raw materials, work in progress, finished products, supplies	Visual No. 8.
(2) Consistency in valuation	

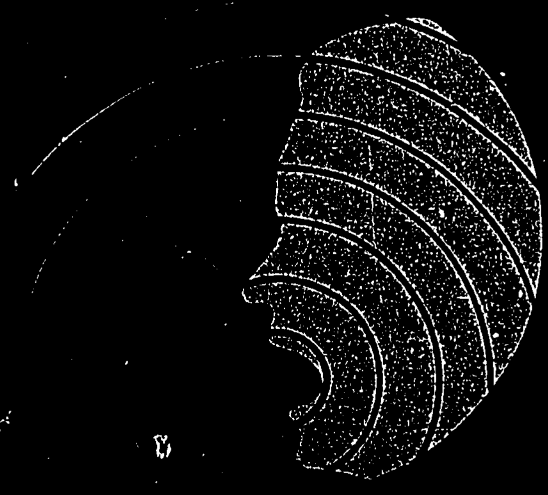
(3) FIFO, LIFO	Explain.
(4) Cost basis	Visual No. 9; any method must be applied to entire inventory.
(5) Lower of cost or market basis	Figured item by item.
(6) Retail method	Discuss fully if group is retail-oriented.
(7) Nonpermissible practices	Mention each, as given on p. 25.
g. Installment sales	Visual No. 4.
(1) Accrual method (2) Installment method	Discuss each method, using examples on p. 26.
h. State and local business income taxes	Discuss pertinent features of State and local laws.
B. Excise taxes	Visual No. 3.
1. Imposed on-- a. Sales of some items b. Use of some items c. Certain transactions d. Certain occupations	Visual No. 10; mention the specific items and transactions meant.
2. Excise Tax Reduction Act of 1965 a. Manufacturers' excise taxes on cars and equipment. b. Excise taxes on diesel fuel and special motor fuels. c. Excise taxes on alcohol and tobacco products.	Discuss the various changes brought about by this legislation, particularly in relation to retail trade.

d. Excise taxes on tires and tubes, truck parts and accessories	
3. Highway use tax	If useful, pass out copies of IRS publication No. 349, Federal Use Tax on Trucks, Truck Tractors, and Busses.
4. Occupational excise tax; levied on gaming devices, liquor, narcotics, gambling, firearms	
C. Employment taxes	Visual No. 3; Visual No. 11.
1. Types	
a. Federal withholding b. Unemployment c. Social Security d. Corresponding State and local taxes	Discuss, as appropriate.
2. Withholding taxes	
a. Definition of employee	Instructor will want to use examples that apply to the local situation.
b. Withholding exemption certificate (Form W-4)	Pass around copies of both Form W-4 and Circular E, Employer's Tax Guide.
(1) Minimum withholding (2) Sick pay exclusion	
c. Definition of wages	Read (and, if necessary, explain) the definition used in the most recent edition of Tax Guide for Small Business. Also discuss bonuses, rewards, gifts, tips, etc.

3. Withholding deposits	
a. Must be in Federal Reserve Bank or authorized commercial bank.	
b. Quarterly return c. Employer ID number	Pass around copies of IRS Forms 941 and SS-4.
4. Unemployment taxes	
a. Who is obligated b. Rate of tax c. Credit for State unemployment tax paid	
5. Self-employed benefits	Visual No. 12.
a. Self-Employed Individuals Retirement Act of 1962 b. Inclusion of employee	IRS Document No. 5592 explains requirements of the act.
IV. ESTATE AND GIFT TAXES	
A. Advantages of a will	
1. Marital deduction 2. Disposition of business interests	
B. Gift tax deductions 1. Nontaxable gifts 2. Specific exemption--$30,000 3. Charitable deduction 4. Marital deduction	Visual No. 13; each item should be discussed fully, time allowing.
C. Split gifts	

D. Estate tax	
1. Estate tax is an excise tax	
2. Estate consists of--	
a. All decedent's property	
b. Jointly held property, annuities, life insurance	
E. Financial planning needed	
1. Itemize assets of gross estate	
2. Estate tax a prior lien	
3. Liquid assets essential	
F. The "marital deduction"	Visual No. 14.
1. Estate left to wife	
2. Estate left in trust	
3. Property interests which qualify	Note items on p. 35.
G. The lifetime gifts	
V. TAX ADMINISTRATION	
A. Goal of tax collection--fair share	
B. ADP (automatic data processing)	
1. Uses of ADP	List given on p. 35.
2. Why returns are audited	Visual No. 15.
3. What returns are checked for	Visual No. 16.
4. Questions may arise	Discuss topic given on p. 37 and any others present owing to local problems.

5. Need for adequate records	Discuss, usingas example those businesses represented among the course participants.
6. Three cautionary rules	Visual No. 17.
a. Avoid cash transactions b. Pay by check c. Deposit all payments	
7. Getting an advance ruling from IRS	
C. Rights of appeal	
1. Steps in appeals procedure 2. Jurisdiction of U. S. Tax Court 3. Appealing an adverse decision 4. Legal counsel recommended	Visual No. 18.
VI. CONCLUSION	Hand out Focal Points No. 8

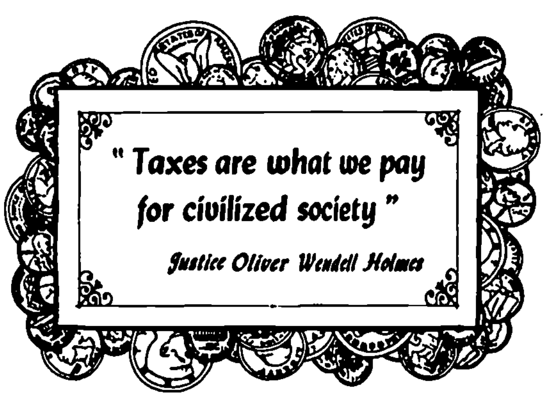


TAXATION: A KEY FACTOR IN BUSINESS DECISIONS

Some centuries ago, Robert Herrick, an English poet, and tax-payer, remarked: "Kings ought to shear their sheep, not skin them." He was talking about taxes. Those of you who have recently paid a tax bill probably agree with him.

But despite what some may think, the Federal Government is equally concerned with the tax problems of its citizens. The problems you face as small-business men prompted SBA to offer sessions such as this to familiarize you with Federal tax laws.

There is nothing strange or inconsistent about this. Taxes are not designed to sap the life of the economy or make paupers out of us. Rather, taxes supply the revenues needed to pay for national defense, to support domestic programs considered vital to the Nation's health



Visual 8-1

and welfare, and to meet the commitments our Nation has abroad. As Justice Holmes expressed it, "Taxes are what we pay for civilized society."

The government wants you to pay no more than your legal obligation--but no less. And the better you understand your tax obligations, the more likely you will pay only what you owe.

The classic justification for paying no more in tax than the law requires was given by Judge Learned Hand. He said: "Over and over again courts have said that there is nothing sinister in arranging one's

affairs to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands."

Knowledge of taxes is important to you because some incomes are taxed at a higher rate than others. Furthermore, certain business transactions are taxed differently than others while those in the same class or group are subject to the same requirements. Because tax requirements are not always known, businessmen frequently fail to take advantage of all possible tax benefits.

(Generally, when I speak of taxes I will be talking about Federal taxes; but you should not forget the State and local taxes which will also affect your business.)

When you do not have the services of a competent tax adviser available, you may be making business decisions without fully understanding their tax consequences. One way to improve this situation is to find out what you can about taxes.

One source of information and assistance is the Internal Revenue Service. If you have a tax problem, the Internal Revenue Service offers year-round counseling to businessmen concerning their tax problems. Also, IRS annually publishes the excellent handbook <u>Tax Guide for Small Business</u>. It covers a multitude of tax considerations--from starting a business to running it, selling it, or giving it away.

MANAGEMENT AFFECTS TAXES

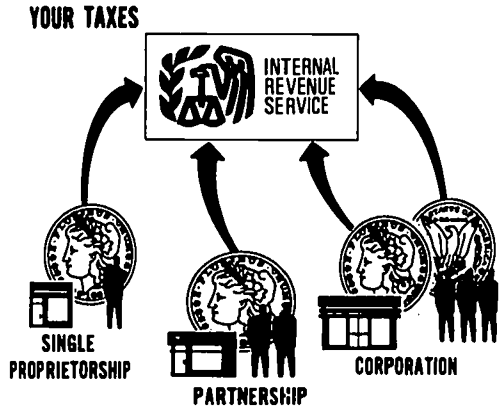
A vital aspect of sound management is knowing and appreciating the importance of tax considerations in making business decisions. They can turn a profit into a loss or give substantial value to a business being operated at a loss. As a small businessman, you must be aware of the tax consequences of the business decisions you make.

Business Decisions and Tax Consequences

In other words, how you manage can affect your taxes. When you make a business decision you should know what will be involved in the matter of taxes.

Look at what might happen if you should make a decision without such knowledge. Take, for example, the decision you have to make about the manner in which you choose to be taxed--as a corporation, partnership, or proprietorship, as the case may be.

YOUR FORM OF BUSINESS ORGANIZATION CAN AFFECT YOUR TAXES



Visual 8-2

Suppose, for instance, that you decide being taxed as a corporation will benefit your firm. Suppose further that you decide this without seeking advice or fully analyzing your choice.

Have you made a wise decision?

Although your business makes an average income, electing to have it taxed as a corporation may not be as advantageous as being taxed as a proprietorship or partnership. Not only is the corporation obligated to pay taxes, but the income of the owners is also taxed. To some extent this is a double tax on the same income. These are just basic considerations, but how often are they taken into account?

Electing to be taxed as a corporation may not produce the most advantageous income tax situation for you, but it may still be in the best interest of your company for other reasons. I'm not suggesting that tax consequences should control or dominate management decisions. But you must consider the tax consequences before you make your management decisions.

Laws and Management Decisions

Congress has passed important tax legislation recognizing the particular needs of the small-business man. The Small Business Investment Act of 1958 and the Small Business Tax Revision Act of 1958 made equity capital more available to small concerns. They also dealt with certain specific business problems such as carrying back a net operating loss and granting an additional first-year depreciation allowance for small concerns.

Recent changes in tax application are also very important to the small-business man. Revised rules for depreciation issued by the Treasury Department set forth new guidelines on the useful life of machinery and equipment. On the whole, the new useful lives are 30 to 40 percent shorter than those previously suggested. According to the Treasury, the new guidelines will permit American businesses to take more rapid depreciation than previously was taken on 70 to 80 percent of the machinery and equipment used.

An important feature of the Revenue Act of 1962 was the 7 percent investment tax credit allowed on the purchase of certain types of new and used business equipment.

The Self-Employed Individuals Tax Retirement Act of 1962 set up certain regulations concerning voluntary pension plans which give the self-employed tax advantages similar to those already available to executives and employees of corporations.

By the Revenue Act of 1964, normal tax on the first $25,000 of taxable corporate income was reduced from 30 percent to 22 percent. Also, the total tax on income in excess of $25,000 was reduced from 52 percent to 48 percent for tax years beginning after 1964. In addition, personal income tax rates were reduced from a range of 20 to 91 percent to a range of 14 to 70 percent.

You Must Decide

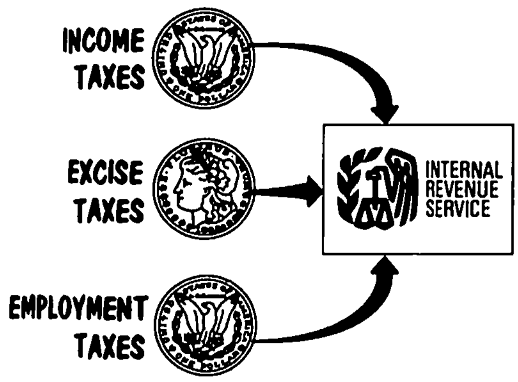
The Internal Revenue Service can point out to you the various laws and regulations you should consider. And the Small Business Administration can provide publications on the kinds of records to keep for income tax purposes and on other tax subjects. (SBA also provides assistance on management factors, such as the improvement of accounting methods which may help a firm to reduce overhead, isolate unnecessary costs, and itemize expenses so that they may be attributed to specific transactions. Such assistance may, as a byproduct, improve your tax position.) But you have to make your decisions. This is especially true of business matters affected by taxes.

It is my hope that this session will point you, the small-business man, in the right direction insofar as your basic tax decisions are concerned. Then you will be able to take full advantage of the provisions and protections the Government has tried to build into the tax laws. I also want to call attention to some of the tax consequences which may be present--unseen and unsuspected, perhaps--in the background of a number of common managerial decisions.

Keep in mind also that my purpose is not to have tax considerations overrule your business judgment. I hope rather to make you at least mindful of the tax implications of your decisions.

MAJOR FEDERAL TAXES

Most small-business men must become familiar with three major groups of Federal taxes: income, excise, and employment.



MAJOR FEDERAL TAXES

Visual 8-3

To underscore how important an understanding of these taxes is, consider this fact: A $1,000 reduction in taxes is usually worth more than $20,000 in additional sales. Thus, each dollar spent on tax advice can have as important an effect on your profits as a similar amount spent on advertising, research, or other management activities.

Income Taxes

Forms of Organization

How much your business will pay in income tax depends to a great degree on how it is organized. If it is incorporated, then your profits will be taxed at corporate tax rates, which may be lower than individual tax rates. However, when the profits of an incorporated business are distributed as dividends, they are taxed again at individual rates. Thus, profits from a corporation are taxed twice.

In the other two major forms of business organization, the sole proprietorship and the partnership, profits are taxed only once, at individual rates, even though they may not be distributed to the owners.

Let's give a simple illustration, considering how $1,000 in profits would be taxed under the various forms of business organization. In a corporation, the $1,000 would be taxed at the 22 percent rate applicable on the first $25,000 of corporation profits. In this case, $780 would be left after taxes. If you decide to take all of this money out of the business, you could do so by declaring a dividend in that amount. You would then have $780 to report as income to be taxed at individual rates. Because the first $100 in dividends may be excluded, you would have to pay taxes on $680 at the tax rate for your income bracket.

In a partnership or sole proprietorship, this same $1,000 in profit would not be subject to any separate business income tax. The entire $1,000 would be taxed only once, at rates for individuals.

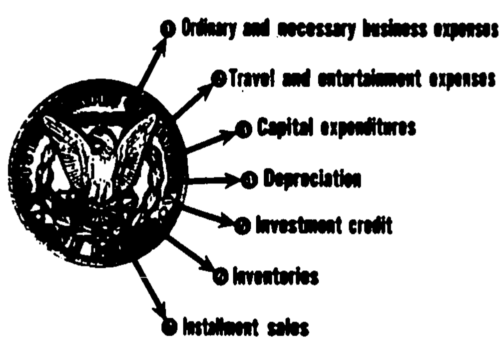
Profits are not the only way, however, to gain income from a corporation. The law provides that one of the deductible business expenses of a corporation is the salary you would pay yourself as manager of the business. Your salary should be comparable to what others receive in similar positions. It would be paid by the corporation to you; and you would declare this amount on your personal income tax.

In many cases, therefore, if you are making a living wage from your business, it will be taxed only at individual rates no matter what form of business organization you choose. A salary paid by a corporation to you, and salary or profits from a sole proprietorship or partnership, would be taxed just as personal income.

Decisions Affecting Taxes

Your tax liability may be affected by decisions on: ordinary business expenses; travel and entertainment; capital expenditures; depreciation; investment credit; inventories; and installment sales.

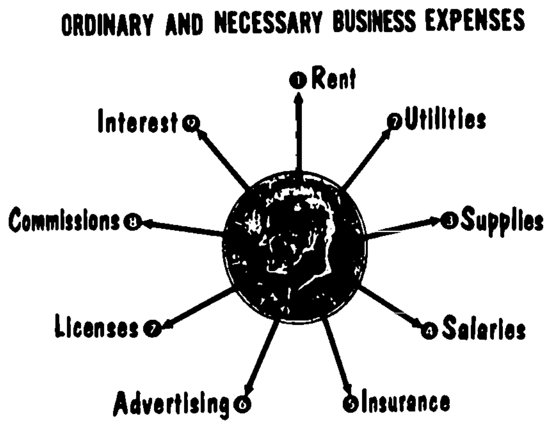
HOW DO YOU HANDLE --



Visual 8-4

Business Expenses

Expenses that are ordinary and necessary to the conduct of the business are usually tax-deductible. Your rent and utilities, supplies,



Visual 8-5

salaries, insurance, advertising, licenses, commissions, interest, and similar expenses are deductible if they have not been included in "cost of goods sold." Each such deduction must be adequately supported by records, of course; and the amount you may deduct for any allowable expense must be reasonable.

Expenses which are both business and personal--such as business property which is used partially for personal purposes--are sometimes difficult to allocate. If you have an apartment over your store, then you must allocate between business and personal the expenses you pay for rent, heat, power, and repairs.

The same would hold true for any other property (including real estate, cars, or trucks) that has a dual business and personal use.

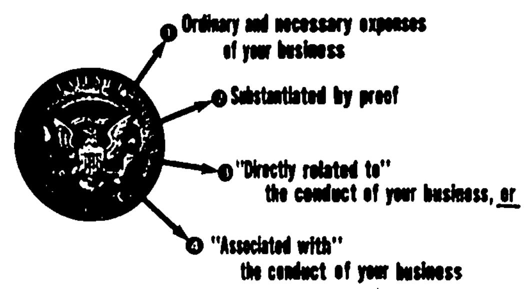
Travel and Entertainment

The overlap between business and personal expenses has been most controversial in matters of travel and entertainment. The Revenue Act of 1962, which was aimed at curbing expense account abuses, has eliminated much of the confusion. This legislation established limitations on business expense deductions for travel and entertainment and outlined the substantiation required to support the deductions.

Briefly, entertainment expenses must be ordinary and necessary expenses of carrying on your trade or business, and you must be able to substantiate them or they will not be allowed as deductions. With

certain exceptions, you must also be able to show that they are "directly related" to the active conduct of your trade or business, or "associated with" the active conduct of your trade or business.

DEDUCTIBLE TRAVEL AND ENTERTAINMENT EXPENSES MUST BE–



Visual 8-6

These new restrictions aim to eliminate the abuses that had begun to crop up in this era of "expense account living." You may recall such cases as the dairyman who charged off his African safari as a promotional expense; or the businessman who paid for his daughter's coming-out party by putting it down as business entertainment. This is the kind of abuse being brought under control; legitimate business entertainment expenses are still deductible.

The new law also reaffirms that the expenses of your wife are generally not deductible when you take her along on a business trip or to a convention, unless you can establish that her presence served a bona fide business purpose. Incidental services, such as typing notes, etc., are not sufficient to warrant the deductions.

Before you include an entertainment item on your tax return, check the Tax Guide for Small Business or IRS Publication No. 463, Rules for Deducting Travel, Entertainment, and Gift Expenses. Otherwise, you may have to pay additional tax because an entertainment deduction is disallowed. A checkup such as this is a good preventive measure too: If you know beforehand that a certain kind of expense is not deductible, you might decide not to spend the money for it at all.

Capital Expenditures

The cost of repairs, improvements, or additions to the business property is another type of expense that gives some businessmen trouble. Some of these expenses are deductible immediately, others have to be capitalized.

How can you tell which is which? Let's use a simple illustration: the difference between painting your building and adding a new wing to it. Painting is a regular maintenance expense which should be deducted along with your rent, light bill, and cleaning supplies. Building an addition is a capital expenditure, and you cannot deduct its cost. Instead, you can recover it through depreciation deductions.

Here's a general rule for determining when an improvement is a capital expenditure: If it has a useful life of more than 1 year, it will either increase the value of the property or prolong its life, and thus will probably have to be capitalized.

Depreciation

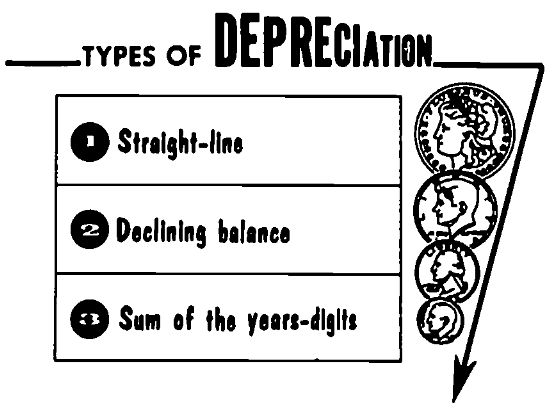
You may claim a depreciation deduction on depreciable business property or income producing property having a useful life of more than 1 year. This includes machinery, buildings, livestock, or similar assets. Land is never subject to depreciation allowance. Intangible assets having a limited period of usefulness--for example, patents and copyrights--may be depreciated. However, goodwill, trademarks, and trade names usually have an indefinite life and are not deductible.

One of the basic concepts in the annual depreciation deduction is that of allowing you a reasonable deduction for the exhaustion, wear and tear, and obsolescense of depreciable property used in your business or held for the production of income. This enables you to recover your cost of depreciable property during its estimated useful life.

Several years ago, the rules on depreciation deductions were liberalized and made much simpler. In most cases, useful lives were shortened, and fewer categories were established. Instead of having to find what life is given for every particular piece of equipment, you only need to find what the useful life is for the operational equipment of your trade or business, and that of two or three general classes of equipment such as office machines. IRS Publication No. 456, Depreciation Guidelines and Rules, lists the accepted useful lives for income producing property. For your copy, send 30 cents to the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402.

The tax laws permit you to choose any one of the several methods set up to handle depreciation accounting. Whichever one you choose should be the one you actually follow, not merely a bookkeeping entry made for tax purposes. In other words, you should set money aside for depreciation according to the method you have chosen for reporting depreciation deductions.

For our examples, let's say you buy a $1,000 piece of machinery with a life of 10 years. Straight-line depreciation is the simplest of the methods. Under it, you would set aside $100 each year in your depreciation account, and this $100 would be allowed as a depreciation deduction on your return.



Visual 8-7

The "declining balance" method permits you to recover the cost of your machine at a faster rate. Here the amount of depreciation taken each year is deducted from the initial cost of the machine before computing the following year's depreciation. The declining balance would work out this way. For the first year, the depreciation allowance would be twice the straight line rate, or $200. The next year, the deduction would be $160: From the $1,000 cost of the machine, subtract the first year's depreciation of $200 to give $800; the depreciation deduction would be 20 percent of this.

When property is acquired new and has a life of 3 years or more, use double the straight line rate. In other circumstances, you should use 1-1/2 times the straight line rate.

The "sum of the years-digits" is the third most commonly used method for computing depreciation. It applies a different fraction each year in figuring the depreciation deduction. Usually it permits you to recover cost of assets faster than if you used the straight-line method.

To figure the fraction, square the life of the asset, add the life, and divide by two. With our $1,000 machine, we would get:

$$10 \times 10 + 10 \div 2 = 55.$$

Our result, 55, is the denominator of our fraction. In the first year, you would deduct 10/55 of the machine's cost; in the second year, 9/55; in the third year, 8/55; and so forth.

This works out to $181.82 the first year, and $163.44 the second. Note that these amounts are roughly the same as in the declining balance method, but that they are larger than in the straight line method. Under each of these three methods, you must make an allowance for salvage value, the amount you think you will get when you retire an asset from service and sell it.

In addition to depreciation deductions, there is also a 20 percent deduction allowed on certain property during its first year of life. This property must have a life of at least 6 years and be tangible personal property, not land or buildings.

Assets that would qualify for this additional depreciation allowance would be machinery and equipment used in your business or for the production of income. Both new and used equipment qualify.

If you choose straight line depreciation on your $1,000 machine with a useful life of 10 years, then in the first year you could take a $280 deduction: your 10 percent regular depreciation deduction, plus your 20 percent first-year allowance. With the declining balance method, your first year's deduction would be $360.

Investment Credit

The investment credit is an important provision recently added to the tax laws. It was designed to encourage businessmen to invest in new plant and equipment by allowing them to reduce their tax bill by a portion of their investment. You may take a tax credit of up to 7 percent for investments that qualify. In other words, your tax bill is cut by that amount.

To qualify for the credit, the assets you acquire must have a useful life of at least 4 years. For assets with a life of 4 but less than 6 years, figure the credit at one-third of the cost. For 6 but less than 8 years, use two-thirds of the cost. And for assets with a useful life of 8 years or more, use the full price.

To cite an example, suppose you buy a piece of equipment costing $9,000. If it has a life of 4 years, then you take a tax credit of 7 percent of $3,000 (1/3 the cost of the equipment), thus reducing your total tax bill by $210. If this $9,000 investment has a life of 6 years, your tax credit is 7 percent of $6,000, or $420. If its life is 8 years, then your credit is 7 percent of $9,000, or $630.

If you can't use all your credit in any one year (that is, if the amount of the credit is greater than your tax liability), then you can

carry it back to the 3 preceding years, and then bring any unused balance forward to the succeeding 5 years. The unused credit is to be used starting with the earliest year, and any excess is to be carried forward to the next succeeding year. Using the investment credit provision may enable you to get a refund on past tax years, or to offset future tax liabilities.

In general terms, this is how the investment credit is figured. There are some limitations for used property; and property you inherit or receive as a gift does not qualify. Also, there are maximum limitations on the amount you can deduct.

Inventories

The value you give to your inventory is an important management decision because it is one of the important factors which determine your business' gross income.

FIVE MAIN TYPES OF INVENTORIES

	Merchandise, or stock in trade
	Raw materials
	Work in progress
	Finished products
	Supplies

Visual 8-8

The five main types of inventories are: (1) Merchandise or stock in trade; (2) raw materials; (3) work in process; (4) finished products; and (5) supplies (which will physically become part of the item intended for sale).

To clearly reflect your business' income, you must be consistent in your inventory valuation from year to year. You can't handle your inventory one way one year, change to something else the next year, and then go back to the first method in the following year.

Most small-business men use the so-called first-in-first-out method (FIFO) to identify inventory items. This assumes that the items first purchased or produced are the first ones sold. The last-in-first-out method (LIFO) is usually not employed in small business; if you wish to use it, check with your IRS district director.

Using the FIFO method, you can value your inventory items in two ways: by the cost basis, or by cost or market basis, whichever is lower. There are differences in application of the methods.

INVENTORY VALUATION USING COST BASIS, INCLUDE–

1	Inventory price of goods on hand
2	Cost of goods acquired
3	Cost of goods produced

Visual 8-9

If you use the cost basis, you must apply it to the entire inventory and include:

1. The inventory price of the goods on hand at the beginning of the year.

2. The cost of goods acquired during the year, including transportation expenses or other acquisition costs.

3. The cost of goods produced during the year. (Include raw materials and supplies used in the product, expenditures for direct labor and overhead, and an applicable portion of management expenses. Do not include selling costs.)

If you elect to use the lower of cost or market basis, count each item in your inventory and determine what its cost was and what its market value is. Then choose the lower value for each item. You cannot use this method to take the lower of cost or market value of your entire inventory. You must figure it item by item.

Retailers may price inventories by "the retail method." Using this system, you reduce your goods to approximate cost by subtracting the appropriate markup from the retail selling price of each separate department or class of goods.

Several practices are not permissible in computing the value of your inventories: deducting a reserve for price changes, valuing work in progress at a nominal price or less than its actual value, omitting portions of stock on hand, using a constant price, and including stock to which you do not actually hold title.

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Installment Sales

If a good percentage of your income comes from installment sales, the way you handle these on your tax return could have an effect on both your working capital and your yearly tax liability.

Consider the tax difference between the accrual method of accounting and the installment method in the tax of a $1, 000 installment sale. Under the accrual method, you report the entire $1, 000 in the year of the sale. If your profit on the sale is $300, you are taxed on $300 even though you do not receive all of it.

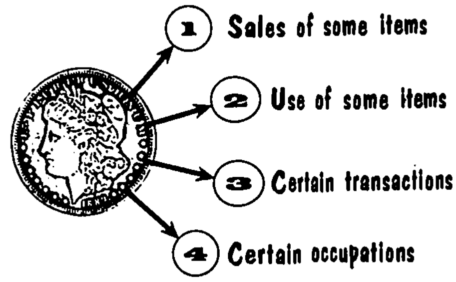
In contrast, under the installment method, you only report what you receive during each tax year. If the $1, 000 sale is spread over a 2-year period, then you report only half your profit in the year the sale is made. In other words, you pay tax only on half the $300 profit instead of the whole amount.

Because the tax law on installment sales is so complex, it will be to your advantage to carefully explore the options open to you before you decide how to handle the taxes on such sales.

This brief rundown of business expenses, depreciation, investment credit, inventories, and installment sales has indicated how important taxes are in each of them. You should keep in mind, too, that State and local governments also levy business income taxes and that, in many cases, their tax policy toward business income differs from their policy toward income from other sources.

Excise Taxes

EXCISE TAXES ARE IMPOSED ON–



Visual 8-10

In contrast to income taxes, Federal excise taxes are not imposed on business profits. Instead, they are imposed on the sale or use of some items, on certain transactions, and on certain occupations.

As you know, the Excise Tax Reduction Act of 1965 removed the excise tax altogether on many items, and reduced it in stages for others. The tax on a few items was left unchanged.

Retail excise taxes on most consumer items were eliminated under the new law. What remains are manufacturers' excise taxes on cars and equipment and the excises on alcohol and tobacco products. Note, however, that an excise tax of 4 cents a gallon remains on diesel fuel and special motor fuels. (If you have any question about the excise tax liability in your business, check with your local IRS office.)

Manufacturers' excise taxes you may be concerned with are those on tires and tubes and truck parts and accessories.

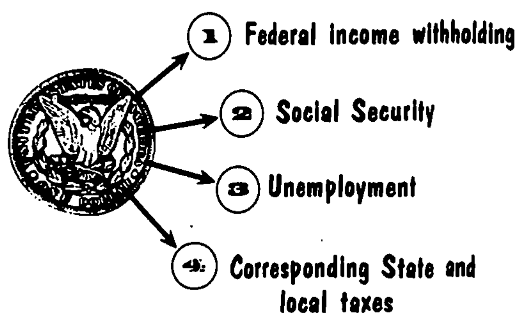
If you are liable for any taxes, you must file a quarterly return. When you owe more than $100 a month in excise taxes, you must make monthly deposits of this tax in a Federal Reserve Bank or other authorized depository.

One excise tax which may affect more small-business men than any other is the highway use tax. This is levied on every motor vehicle meeting minimum weight standards which operates on the highways.

Therefore, if you own and operate trucks in your business, you may have to pay the highway use tax. The specifics about this tax can be found in IRS Publication No. 349, Federal Use Tax on Trucks, Truck Tractors, and Buses.

If you are engaged to any extent in occupations involving gaming devices, liquor, narcotics, gambling, or firearms, you are required to pay an occupational excise tax. You can get the details on this matter from your nearest IRS office.

EMPLOYMENT TAXES



Visual 8-11

Employment Taxes

Employment taxes include Social Security, unemployment, and Federal withholding taxes. If you have one or more employees, you will have to withhold Federal income taxes from the wages you pay. (You may also have State and local taxes to be withheld.)

Withholding Taxes

If you have any question about whether someone who works for you is considered an employee, here are the tax law rules:

Any individual who performs services subject to the will and control of an employer, both as to what shall be done and how it shall be done, is an employee.

Usually considered an employee under this rule would be the barber who leases a chair in a barber shop, the carpenter who works regularly for a building contractor, the helpers a truck driver hires to unload shipments at places where the company does not have terminal facilities, part-time popcorn or hotdog sellers at a ball park, and craftsmen hired by a subcontractor in the building and construction industry.

At the beginning of each year, ask every employee to file a withholding exemption certificate (Form W-4) with you.

Using Circular E, Employer's Tax Guide, put out by IRS, you will be able to determine how much to withhold for Federal income taxes in relation to the number of exemptions the employee claims. This publication shows the amounts to be withheld when an employee is paid daily, weekly, biweekly, monthly, semimonthly, quarterly, semiannually, or annually.

The law on tax withholding specifies the minimum that must be withheld. But you can withhold more than this minimum if an employee requests it. Many do, either to avoid owing tax at yearend or to get a tax refund. Under no circumstances, however, may you withhold less than the law requires. Note, however, that if an employee requests you to stop withholding for Federal income taxes when he is absent because of accident or illness, you may do so if he meets the requirements for sick pay exclusion.

The law considers Christmas bonuses, rewards, and other payments of cash (or items convertible to cash) to be wages. Income tax must therefore be withheld. Gifts of merchandise and facilities such

as meals or medical services are not subject to withholding if they are of relatively small value.

The 1965 Social Security law made an employee's cash tips subject to withholding if they equal or exceed $20 per month. Previously, tips had been considered taxable income, but employers had not been required to apply either withholding or Social Security tax on them.

Now, if their cash tips equal or exceed $20, your employees are required to report this income to you, and you must then adjust the amount of tax withheld accordingly. You must also withhold Social Security tax on tips. This tax on tips falls only on the employee. Employers do not have to match employee contributions, as they are required to do on wages.

To sum up, the law requires you to withhold Federal income taxes from the wages and other monetary remuneration you pay an employee. You must also withhold Social Security taxes from an employee's pay and match the employee's contribution. On tip income, you must withhold income and Social Security taxes for the employee, but you do not have to match the employee's contribution.

Withholding Deposits

Income tax withholding rates begin at 14 percent. Social Security taxes will rise in stages to about 11 percent of the first $6,600 paid to each employee. (NOTE: These rates were in effect at publication. Check current rates before using any percentages.)

If the sums you withhold amount to more than $100 a month, you are required to deposit them in the Federal Reserve bank serving your district or in a commercial bank authorized to accept them.

Whether or not the amount of tax you withhold from your employees' salaries exceeds $100 a month, you are required to file a quarterly return on Form 941 with the IRS. Before filing this return, you must apply for an employer identification number which will identify your withholding payments and other tax returns. To get this number, file Form SS-4 with the District Director of Internal Revenue or the nearest office of the Social Security Administration. This identification number is not the same as your Social Security number, which is required on individual tax returns, so make sure you use the right number on the right return.

You must file a withholding return every quarter, even if you do not pay any wages at all during the quarter. If your business is seasonal or if you suspend operations, you should note on your quarterly

return the date you last paid any wages and the date you expect to begin paying them again. (If an employer goes out of business, he should mark "Final Return" at the top of Form 941.)

The monthly deposit requirements were set up to prevent the use of withheld funds for working capital. Willful failure to file Form 941 or to pay the tax, or willful filing of false or fraudulent returns, can lead to both criminal and civil penalties.

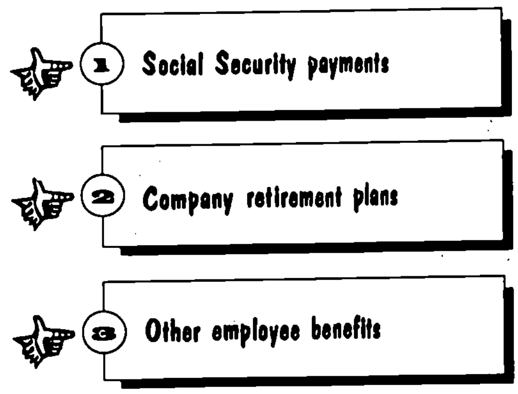
Unemployment Taxes

Besides income and Social Security taxes, you are liable for Federal unemployment tax--if you employ four or more persons for at least 1 day in each of 20 weeks during the year. The weeks do not have to be consecutive. This unemployment tax is scaled to the rate of 3.1 percent of the first $3,000 in wages paid to each employee, and there is no withholding. If you pay a State unemployment tax, you are allowed a credit of as much as 2.7 percent on the first $3,000 paid to each employee. File your annual return on Form 940, and pay the full tax by January 31 of each year.

Self-Employed Benefits

If your business is incorporated, then you as an employee of the corporation are eligible for Social Security benefits, company retirement plans, and other employee benefits. Until recently, the law made

SELF-EMPLOYED BENEFITS



Visual 8-12

no comparable provision for those operating sole proprietorships or partnerships. But this picture changed with the passage of the Self-Employed Individuals Retirement Act of 1962.

Under the provisions of this new act, one who is self-employed may contribute up to $2,500 or 10 percent of his business' earned income, whichever is lower, to a retirement plan for himself and his

employees. And half of the contribution may be deducted as a business expense.

If you decide to set up such a plan, you must include any of your employees who have worked for you for at least 3 consecutive years. For requirements of the self-employed retirement law, ask the nearest IRS office for a copy of Document No. 5592.

ESTATE AND GIFT TAXES

At some point in your business career, you are likely to encounter Federal estate and gift taxes. You may want to give your family a share of your business before you retire, or perhaps you want to make sure that your children will be able to continue the business if they wish. Gifts of common stock or other property are often given to a child to reduce the donor's estate and therefore the amount of Federal estate taxes payable by the estate.

In either instance, you would be involved with estate and gift taxes. Because these two taxes are so closely related let's consider them together.

Advantages of a Will

If you hope to reduce your estate taxes, the advantage of having a will cannot be overemphasized. With a will, you can be sure of using the marital deduction and can determine the portion of your estate that will bear the tax. Without a will, your estate taxes may be higher, and you will have no assurance that your business interests and other assets will be disposed of as you would want them to be.

ESTATE AND GIFT TAX DEDUCTIONS

- Nontaxable gifts
- Specific exemption - $30,000
- Charitable deduction
- Marital deduction

Visual 8-13

Gift Tax Deduction

You can reduce your eventual estate tax liability by making nontaxable gifts each year. The gift tax law provides that the first $3,000 of a gift to any one person in any one year is excludable if the person

receives a present interest in the property (that is, actual possession). If you make several gifts of $3, 000 each to different people, each is excludable and not taxable.

The gift tax law also allows donors three additional deductions:

Specific exemption--$30, 000 in a lifetime

Charitable deduction

Marital deduction

The specific exemption of $30, 000 may be taken all in one year, or it may be spread over a number of years. This exemption is personal to the donor and may be used at his option. Here is an example that shows how the exclusion and specific exemption may be used.

Assume that a businessman who owns a closely held corporation gives his son stock having a market value of $25, 000. To this he can apply the $3, 000 exclusion. Now he has a right to apply against the balance of $22, 000 the necessary portion of his specific exemption. Even if he applied $22, 000 of his lifetime exemption and eliminated any possible tax, he would still retain $8, 000 of his $30, 000 specific exexemption which he could use in subsequent years.

The gift tax statute allows you to deduct one-half the value of any property you give your wife (or that a wife gives her husband) during a calendar year. The marital deduction applies to the total value of the property before taking into account the allowable exclusion of $3, 000 or the specific exemption. For example, if during the calendar year you give your wife property worth $80, 000, the amount of the marital deduction is $40, 000. You are also entitled to a $3, 000 exclusion and (assuming it has not been used in previous years) a $30, 000 specific exemption--leaving a net taxable gift of $7, 000, which would be taxed $217.50 under current schedules.

However, the "one-half principle" of the marital deduction must be modified if you make a gift of less than $6, 000. In such a case, the marital deduction is limited to the portion remaining after the annual exclusion has been taken. For example, if your gift is $5, 000, the first $3, 000 is excludable under the annual exclusion, and the marital deduction is not one-half of $5, 000, or $2, 500. It is limited to $2, 000. If the gift is only $3, 000, no marital deduction is allowed because the full $3, 000 is excludable under the annual exclusion.

Split Gifts

What happens if you make a gift to any person other than your wife? The tax law states that such gifts may be considered as having been made one-half by each of you. This privilege is called splitting gifts and applies only if both of you give your consent. You must both file gift tax returns if the total gift is more than $6,000. For a gift of $6,000 or less, only you need file a return, but your wife must consent to the splitting of the gift.

The gift tax, like the estate tax, is imposed on the transfer of property. The taxable amount of a gift is determined by its fair market value at the date of the gift.

Estate Tax

The Federal estate tax is really an excise tax imposed upon the transfer of a decedent's property to his beneficiaries. Unlike an inheritance tax, which is imposed upon each of the beneficiaries according to his inheritance and relation to the decedent, the Federal estate tax is levied on the entire taxable estate.

For Federal tax purposes, the estate consists of all property--real or personal, tangible or intangible, wherever situated--owned by the decedent at his death. It may consist of property passing under the decedent's will as well as of jointly held property, annuities, and life insurance. It may also include property to which a person does not hold title at his death. Property a person believes he has given away may be includable if it was given "in contemplation of death" or if the decedent retained rights to the property or control of it during his life.

Financial Planning Needed

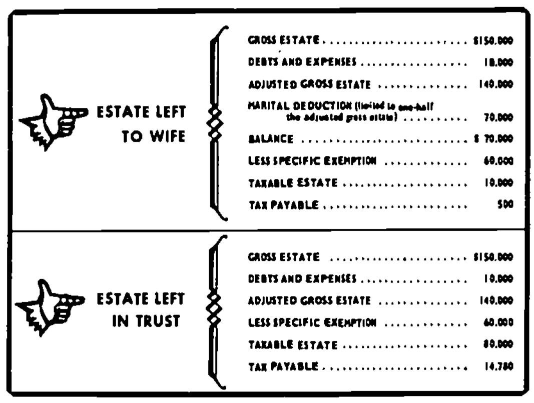
When you itemize all the assets of your gross estate and give each its true fair market value (being careful not to underestimate the value of your business), you may find that the total value is higher than you had thought. An itemization such as this also may point up the need for more cash or liquid assets to pay the estimated estate tax and thus avoid possible liquidation.

Remember that the estate tax, which may be thought of as a prior lien on the estate, is only one of the expenses of settling an estate. Debts, administration expenses, and legal fees compound the problem, making liquid assets essential.

Marital Deduction

If you intend to leave your business to your family, what financial planning can you do so that they will not be forced to liquidate assets to pay taxes and other expenses? First of all, you may be able to reduce the tax on your estate.

MARITAL DEDUCTION



Visual 8-14

The Federal estate tax "marital deduction" may reduce the tax on your estate substantially. This tax provision allows a deduction of up to one-half the value of the adjusted gross estate when the entire estate is left to a surviving spouse. What this can mean to you is shown in the following example:

Gross estate.	$150, 000
Debts and expenses	10, 000
Adjusted gross estate	140, 000
Marital deduction (limited to one-half the adjusted gross estate) . .	70, 000
Balance	$70, 000
Specific exemption	60, 000
Taxable estate	10, 000
Tax payable	500

Let's look at a somewhat different example. We'll use the same gross estate, but in this case assume that the husband would leave the entire estate in trust to pay the income to his wife for life, and that on her death the remainder would be passed on to their children. Then we have the following:

Gross estate.	$150, 000
Debts and expenses	10, 000
Adjusted gross estate	140, 000
Less specific exemption	60, 000
Taxable estate	80, 000
Tax payable.	14, 780

Comparing this with the previous example, you can see that proper use of the marital deduction can be an extremely important device in minimizing your estate taxes.

Explaining the marital deduction would take a complete lecture in itself. Briefly, property interests qualifying for the marital deduction include all property which passes from the decedent to the surviving spouse by will, or property (a) which passes from the decedent to the surviving spouse, and (b) over which she has life estate and a general power of appointment. In principle, therefore, one-half of the decedent's estate might be subject to estate tax in the spouse's estate.

Lifetime Gifts

Another way to reduce your estate tax is to make a lifetime gift of part of your business. If you intend to leave your business to a member of your family (a son for example) there are many advantages to making a gift of a portion of it during your own lifetime. You can reduce the value of your taxable estate by the value of the gift. (The gift is subject to tax, but gift tax rates are approximately 25 percent lower than estate tax rates.) And if you have made no previous gifts, this lifetime gift may not be taxable. Or if it is taxable, then it will be at lower rates.

TAX ADMINISTRATION

Each of you will probably have your business audited by IRS at some time or other. A brief review of what you can expect, what you should know about your rights as a taxpayer, and what you should know about tax administration in general will complete this session.

The approach of the IRS is to administer the laws from a neutral point of view--favoring neither the taxpayer nor the Government. The goal in tax collection is that everyone pay his fair share of taxes--not any more than the law requires and not any less.

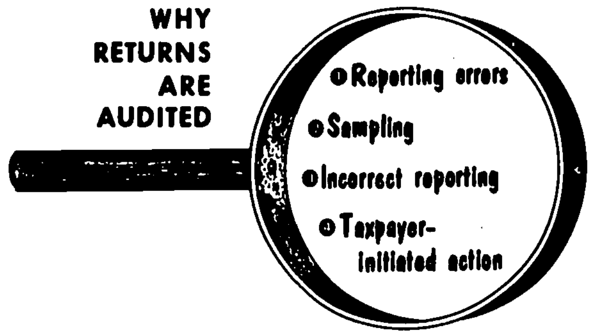
Automatic Data Processing

Automatic data processing, ADP, has been a tremendous help to modern tax administration. Computers and other lightning-fast machines help IRS handle the 100 million tax returns and 500 million information documents (these are reports of wage, dividend, and interest payments) that flow into Federal tax offices each year.

With ADP equipment, IRS is able to:

Make sure taxpayers file the proper returns
Match information documents with tax returns

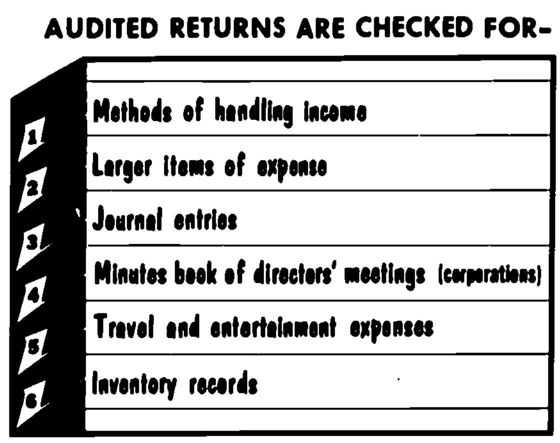
Speed refunds and other operations
Catch refund chiselers
Determine if any other tax is owing before a refund is paid



Visual 8-15

ADP might select your return at random to be audited. Or one of the following reasons might be the cause:

1. Apparent reporting errors in the return
2. Sampling to test and encourage correct reporting
3. Information from various sources indicating incorrect reporting
4. Taxpayer-initiated action, such as claim for refund



Visual 8-16

Should your return be selected, the examining agent will usually check into the following:

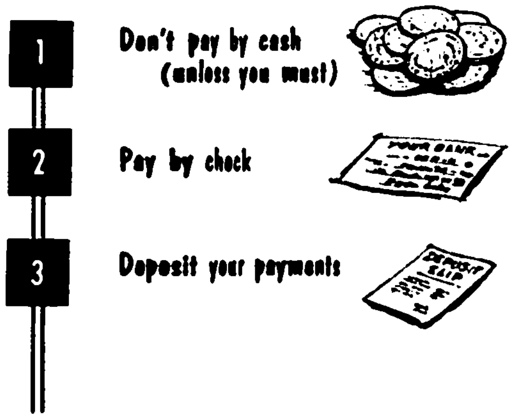
1. Methods of handling items of sales and purchases
2. Large or unusual items of expense
3. Large or unusual cash transactions
4. General journal entries
5. If a corporation, the minutes book of directors' meetings,

and items concerning surplus accounts
6. Travel and entertainment expenses
7. Records pertaining to inventories

Except for obvious errors or apparent fraud, the agent may raise questions involving differences of judgment with respect to such items as depreciation, amounts of allowable expenses or deductions, valuation of inventories, allocation of income or costs between years, and so on. Some of such questions may truly involve differences of judgment, but others will require the presentation of proof or clarification of a deduction claimed.

Obviously, the records you need will vary a great deal with both the type and size of your business operation. Adequate records for one business might be inadequate or perhaps too elaborate for another.

THREE CAUTIONARY RULES



Visual 8-17

It would be good to leave a few words of caution:

1. Keep cash transactions to a minimum
2. As far as possible, make all payments by check
3. Deposit intact all payments received

Disregarding these rules can give rise to more difficulties than almost any other factor in income tax matters.

If you want to know what the tax consequences of a transaction will be before you complete it, you can request an advance ruling from IRS. The ruling will apply the tax laws to the specific facts of your proposed transaction. About 30,000 to 40,000 such rulings are made each year.

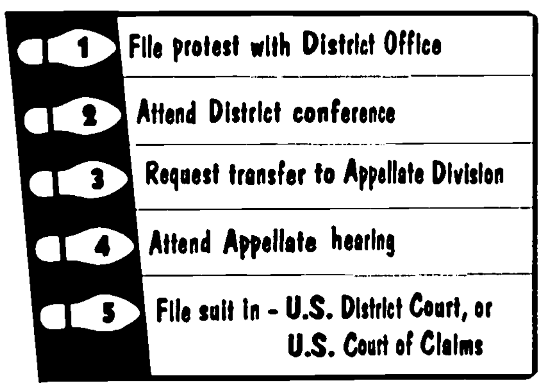
Thus you can pick the most favorable way to handle a business action as far as taxes are concerned. And you can also avoid the unhappy experience of having additional tax to pay because what you thought could be done did not entirely conform with tax law.

Rights of Appeal

Suppose you disagree with the examining agent. There are certain rights of appeal, and you should know them.

Let's say that you and the agent aren't able to reach an agreement when he finishes his examination. A copy of his report will be mailed to you, and you will have 30 days either to accept the recom-

STEPS IN APPEALS PROCEDURE



Visual 8-18

mendations or file a protest with the District Office or the Appellate Division. Your copy of the report will give the name, address, and telephone number of the person who will make arrangements for you for a district conference.

The district conference gives you the chance to state to another IRS representative your reasons for disagreeing with the examining agent. District conferences are held on IRS premises, either at the headquarters office or at the branch office nearest to your place of residence. The decision of the district conferee is based on the applicable facts, law, regulations, or rulings.

If you agree with the conferee's decision, you will be requested to sign an agreement form. If you cannot reach agreement, you can request that your case be transferred to the Appellate Division.

If you do not request a district conference or an appellate conference within 30 days of the conclusion of the initial examination, a statutory notice of deficiency or a statutory notice of claim disallowance will be sent to you by certified or registered mail. If you are sent a deficiency notice, you may pay the tax due and file a claim for a refund, or you may file a petition within 90 days for a hearing before the Tax Court of the United States. If you are sent a notice of claim disallowance, you will have a 2-year period (from the date of the notice of disallowance) to file a suit in either the U.S. District Court or the U.S. Court of Claims.

The Appellate Division is the appeal agency of the Internal Revenue Service and is under the direct jurisdiction of the regional commissioner. A taxpayer need not employ counsel and may appear in his own behalf at these proceedings. However, if a tax problem is complex or particularly involved, it would probably help to have counsel.

Conferences at the Appellate Division are generally conducted on a more formal basis than those at the district level. Negotiations at this stage usually involve questions of tax law rather than questions of fact. In certain cases where the provisions of the law or regulations are not squarely applicable, or where there is no clearcut judicial precedent, the Appellate Division has the authority to consider the hazards of litigation in disposing of disputed cases through a negotiated agreement. Such agreements are generally binding on both parties.

When an appellate hearing is concluded without agreement, the procedures are the same as those described for the district conference. A statutory notice will be issued, etc. Of course, at any point in the appeal process a taxpayer can pay the proposed deficiency, file a claim for refund, and, after the claim is rejected or after a 6-month period, file suit in the U.S. District Court or the U.S. Court of Claims.

The U.S. Tax Court's jurisdiction is limited to matters pertaining to proposed deficiencies in Federal taxes. The court does not consider cases involving claims of overpayment of taxes. The court is located in Washington, D.C., but cases are usually heard by individual judges who travel to various cities. Except for those cases involving fraud, taxpayers generally have the burden of proof to show that the regional commissioner is in error.

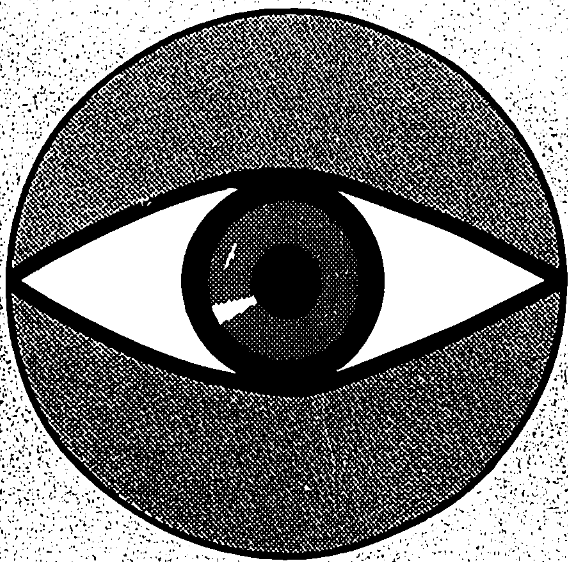
An adverse decision in the Tax Court or District Court may be carried to the U.S. Circuit Court of Appeals, and subsequently to the U.S. Supreme Court. Decisions of the Court of Claims are appealed directly to the Supreme Court.

Although a taxpayer has the legal right to appear on his own behalf, he is almost invariably represented by legal counsel during judicial proceedings. The IRS makes every reasonable effort to reach a mutually satisfactory agreement on a case before it is carried to the courts. Only a very small number of the returns examined, much less than 1 percent, reach a court hearing.

CONCLUSION

One of the requirements for operating a profitable business is attention to tax matters. In this lecture, we have tried to show how the handling of taxes can directly affect your business profits.

Both the Small Business Administration and the Internal Revenue Service provide a variety of services to help you on tax matters. For businesses large enough to afford the services of a management consultant, counsel on tax matters should be given high priority.



THE VISUAL AIDS

A What to Show

Section

The old Chinese proverb "One See Worth Thousand Say" is certainly borne out by experience in the fields of education and training at all levels.

The instructor who helps his participants visualize subject matter and ideas not only holds the group interest — he also stimulates thoughtful consideration and retention of the topic.

This section contains samples of visuals that are available for this subject. Each has been carefully coded and "keyed" into The Lesson Plan as outlined in this manual.

USE OF VISUAL AIDS

WHAT TO USE — **WHEN AND HOW TO USE**

Chalkboard

Study and plan before a meeting what to put on the board and where to put it. Use it to present sketches, diagrams, outlines, definitions, key words, directions, record of class contributions, and summaries.
Suit material to board space.
Write plainly and quickly.
Keep wording simple.
Stand at one side of board while referring to material.
Talk to the group, not to the board.
Erase material no longer needed.

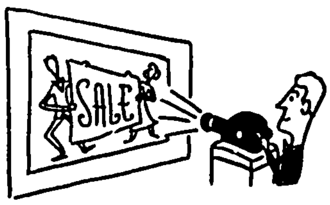
Posters, Charts, and Diagrams

To arouse interest and attract attention; to show relationships and trends; to inspire group.
Use device large enough to be seen.
Post where everyone can see.
Present at right time.
Discuss information illustrated.

Hand-Out Materials

To present information uniform in character and as a guide to material covered; emphasize key points; arouse interest and discussion; review or summarize discussions; and serve as permanent reference.
Select to serve a definite purpose.
Introduce at right time.
Distribute in manner to convey its importance.
Direct members how to use.

Films and Film Strips



Present an overall view; introduce a new subject; emphasize specific aspects of a subject; arouse interest; summarize.
Select carefully to relate to the discussion and plan presentation. Arrange room and equipment for showing. Alert the audience for the showing or what will be seen. Run the film. Discuss the subject matter and summarize.

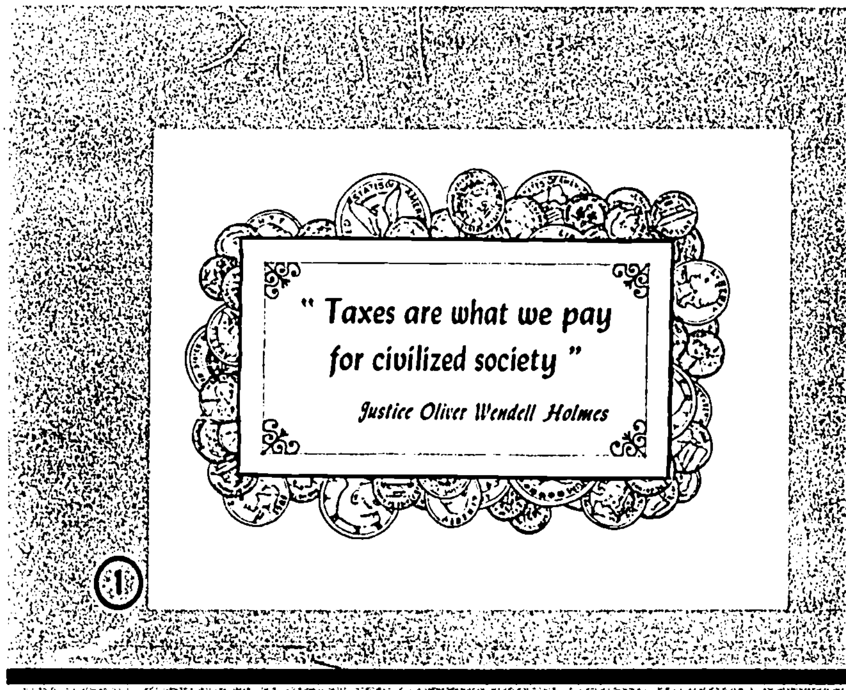
Samples, Forms, and Exhibits

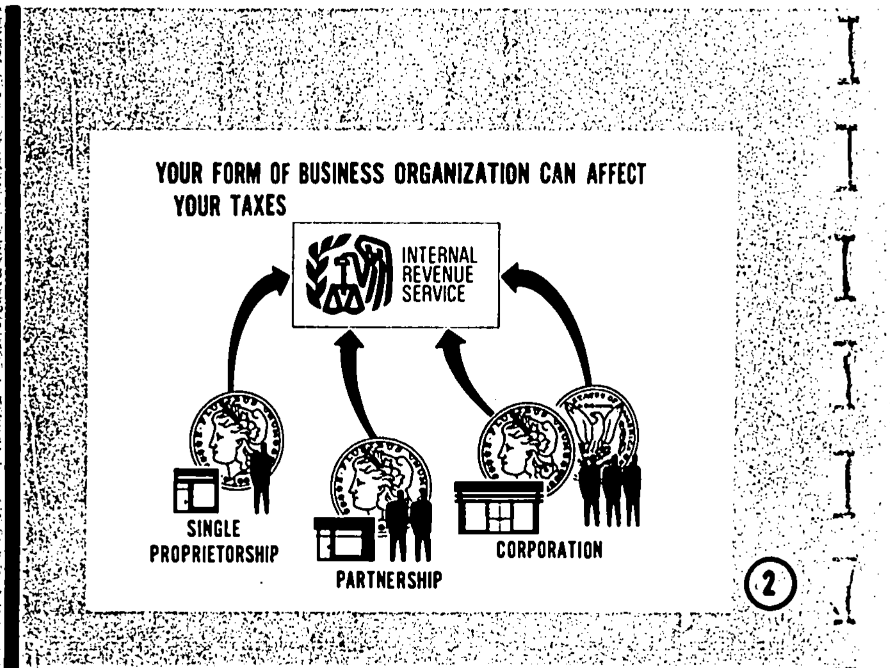
Keep subject matter practical; show development of a process; increase understanding.
Select only enough to illustrate, not confuse.
Pass around if necessary.
Take time to present clearly.
Comment when presenting.

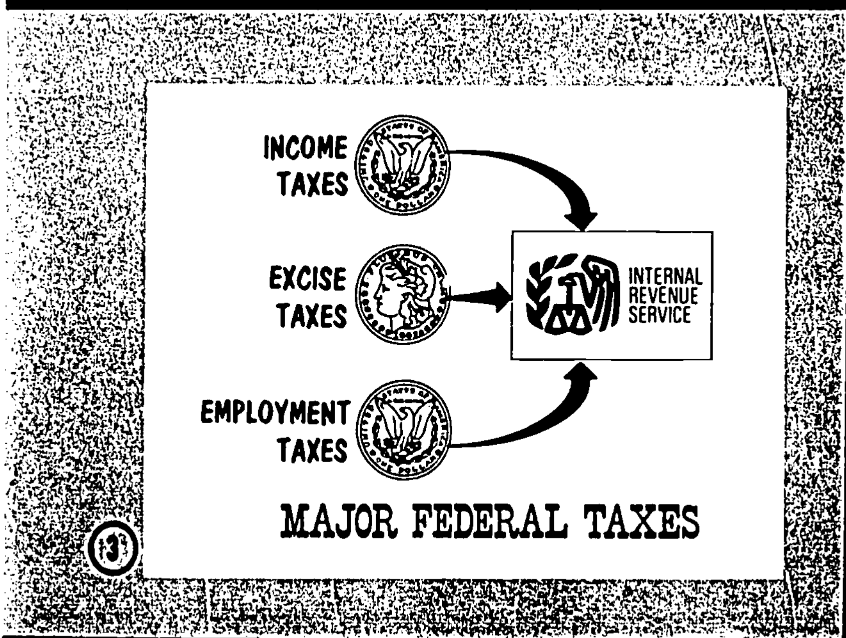
Pedestal Chart

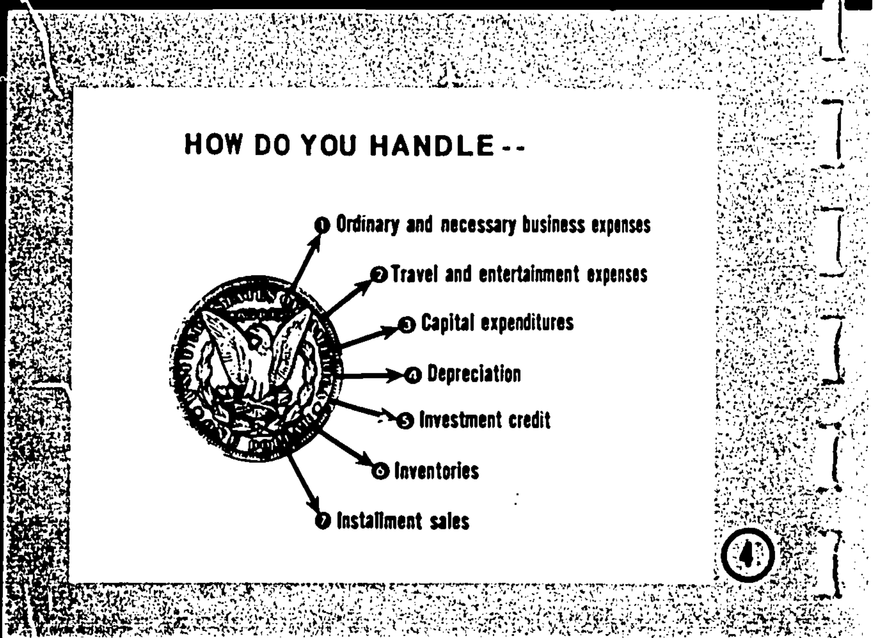
A pad of newsprint sheets or similar paper may be used for the same purposes as the chalkboard. Material recorded with chalk or crayon may be saved for future reference by the group or by the instructor.

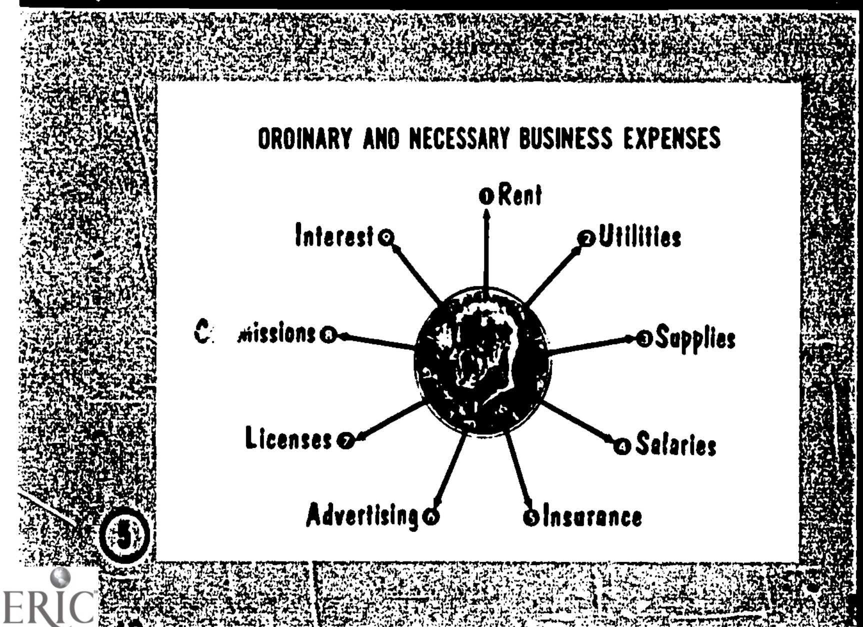
OVERHEAD PROJECTUALS

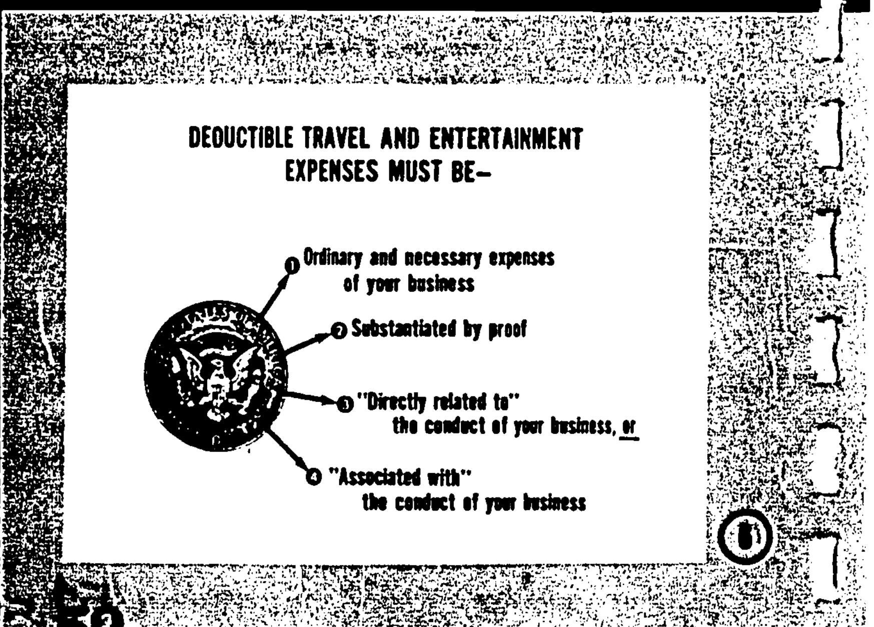




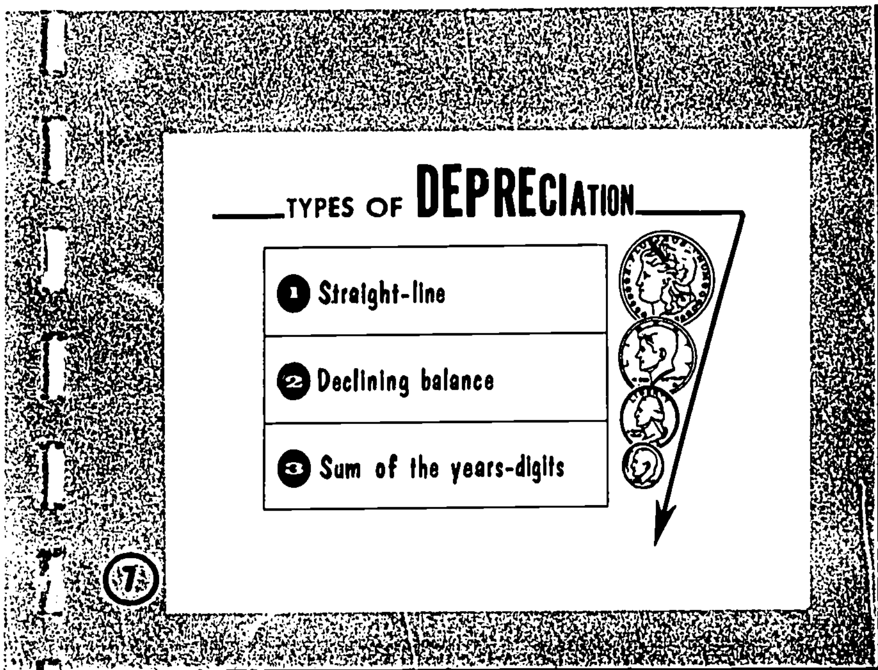


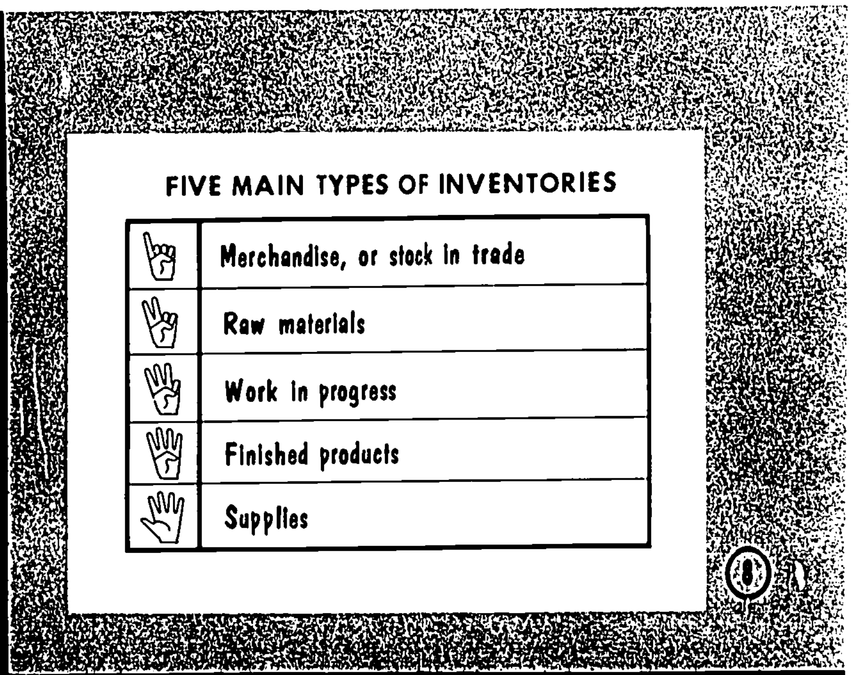


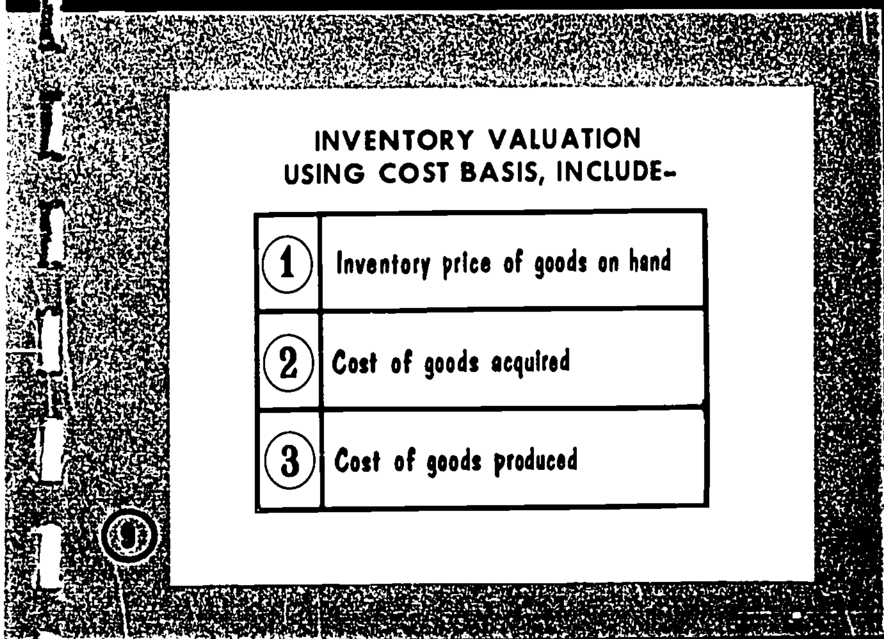


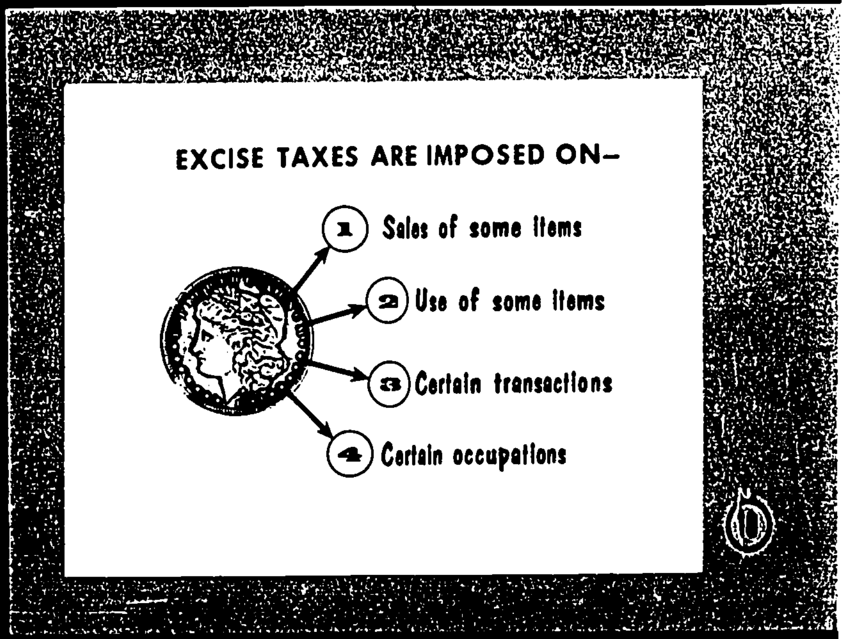


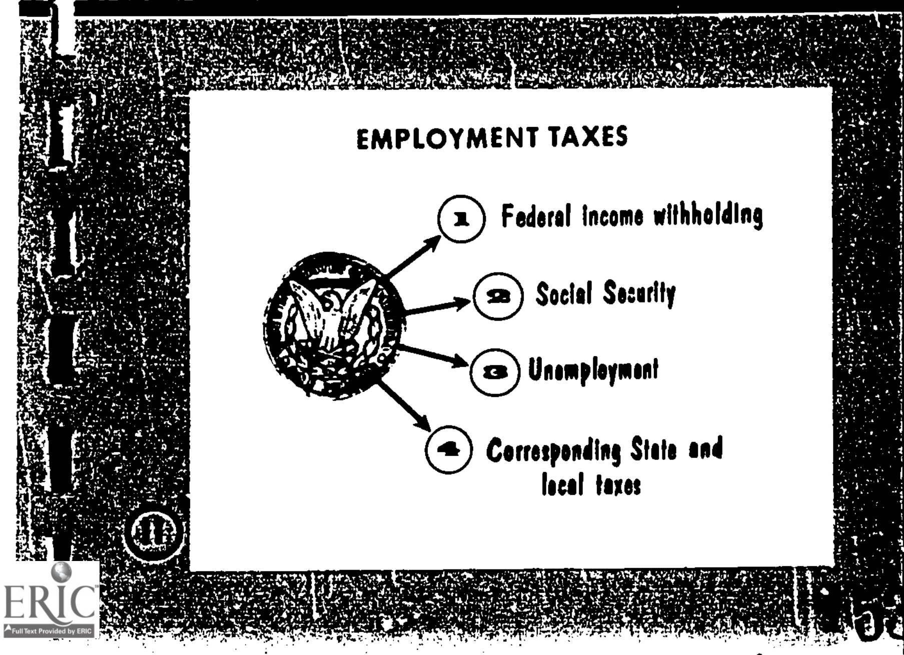
OVERHEAD PROJECTUALS

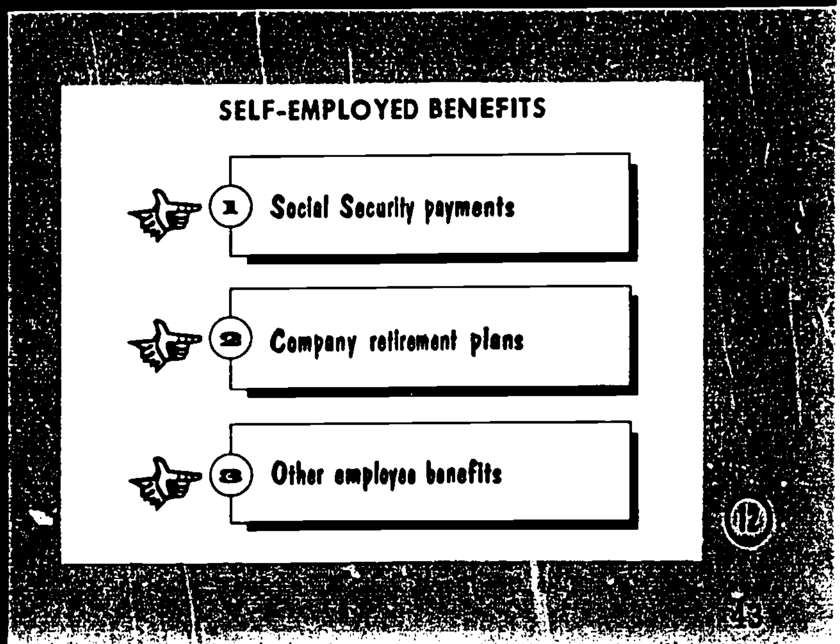




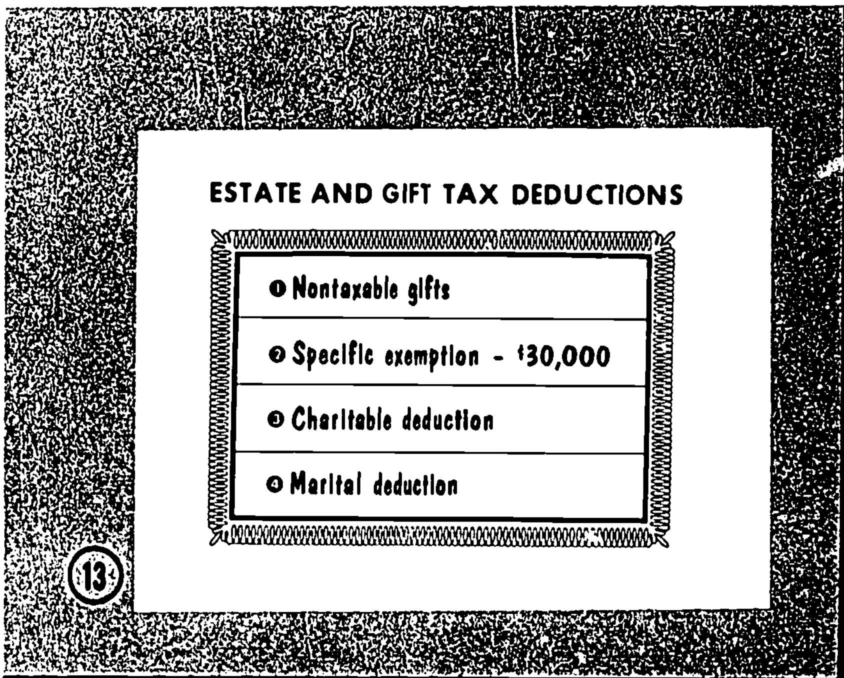


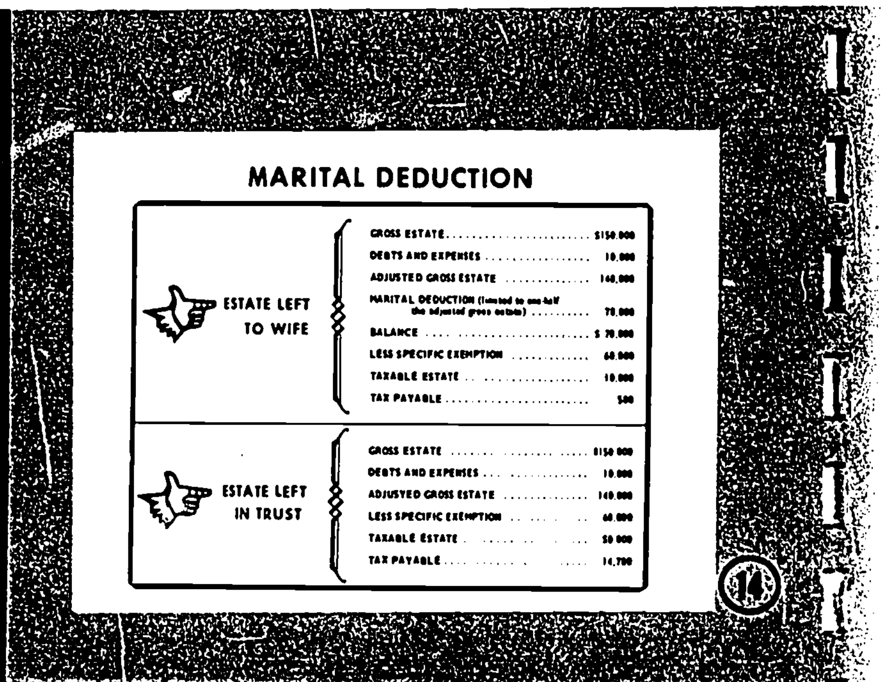


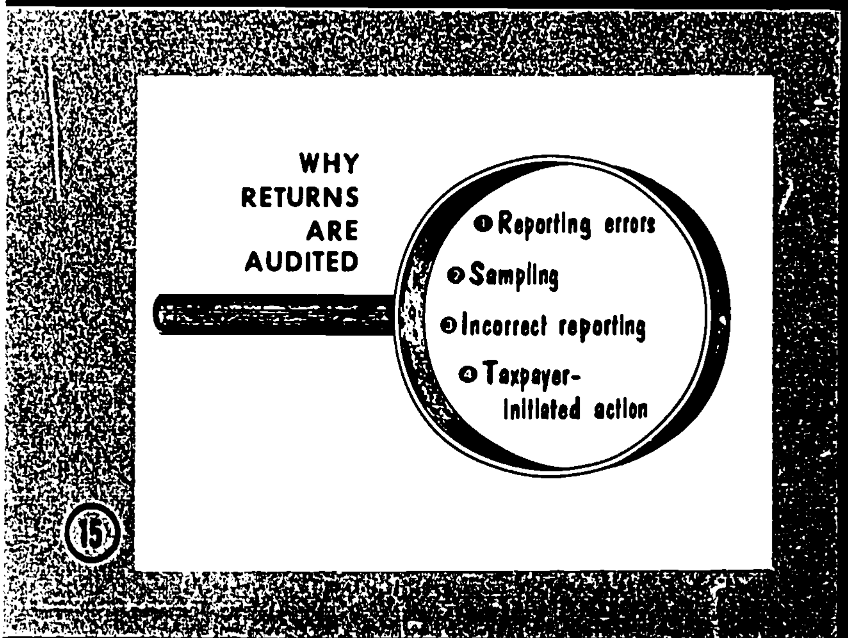


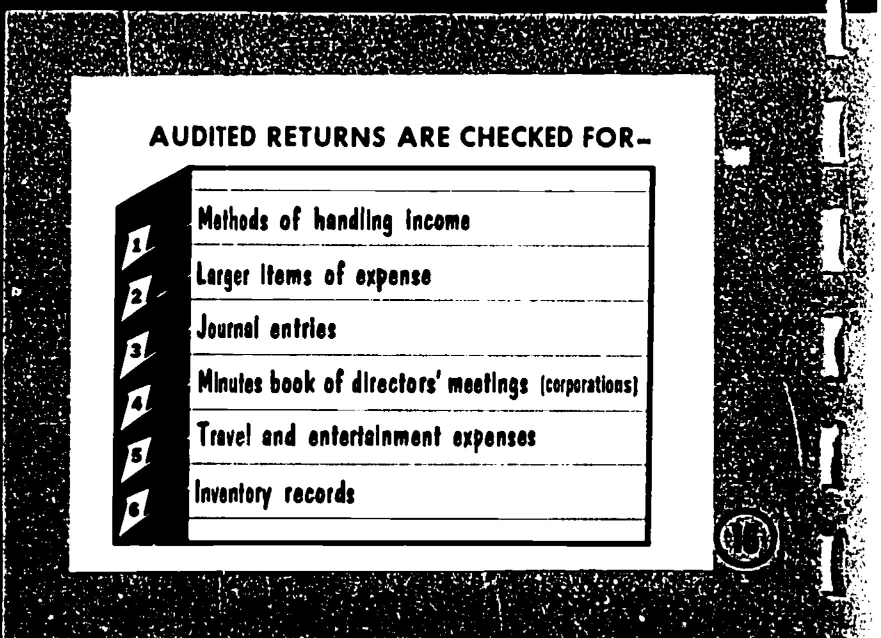


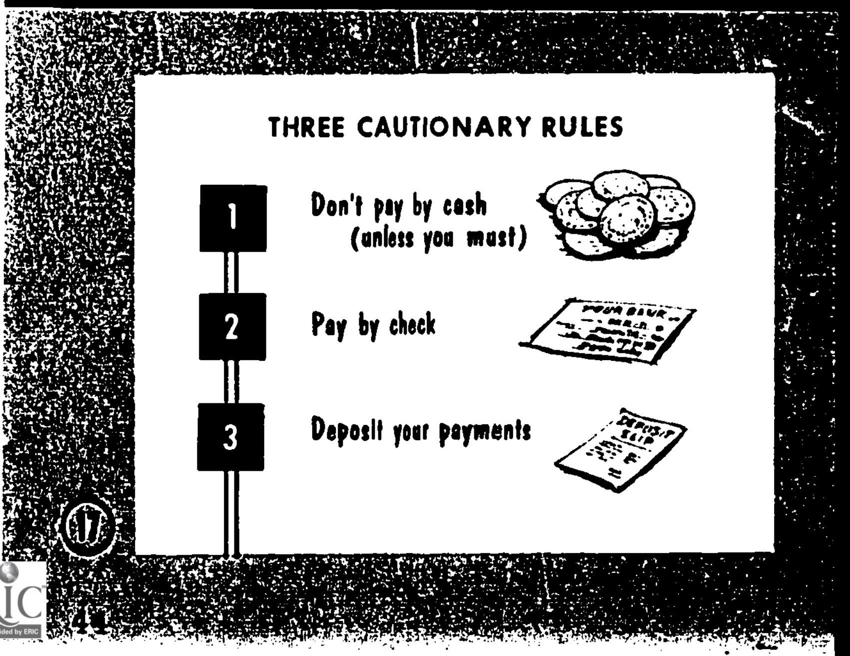
OVERHEAD PROJECTUALS

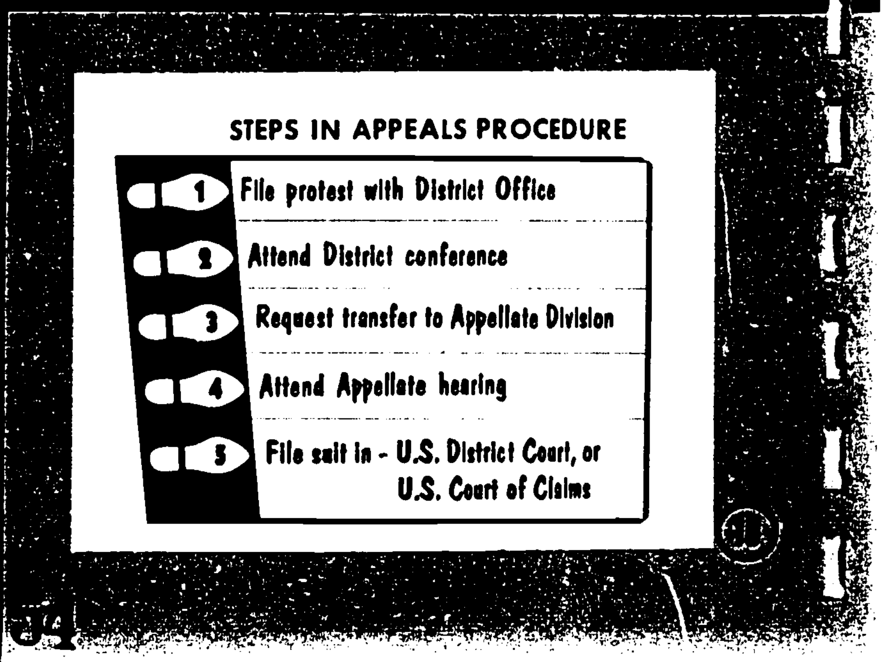












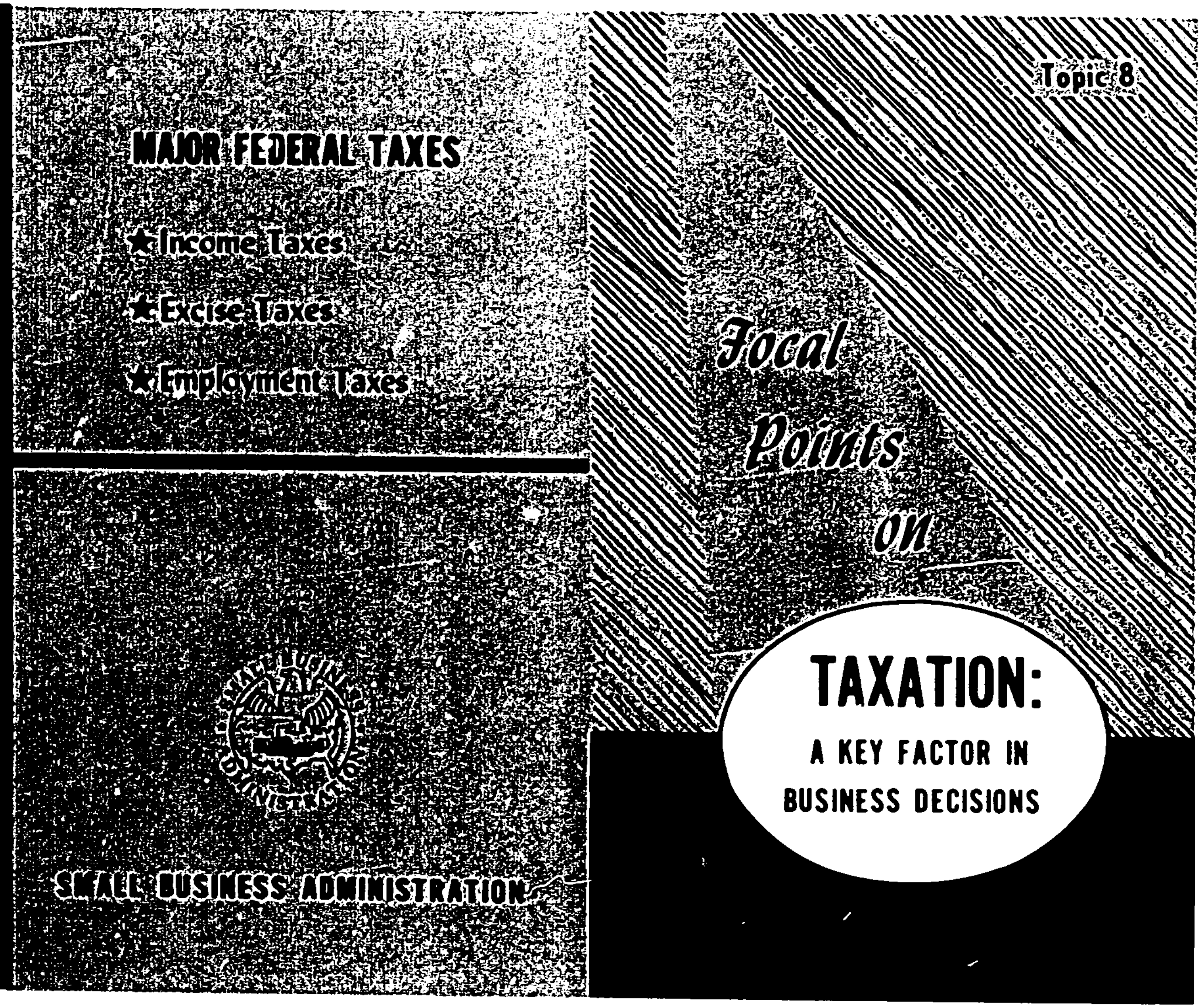
TAX LAWS THAT AFFECT SMALL BUSINESS

1. Small Business Investment Act of 1958
2. Small Business Tax Revision Act of 1958
3. Revised Rules for Depreciation
4. Revenue Act of 1962
5. Self-Employed Individuals Retirement Act of 1962
6. Revenue Act of 1964
7. Excise Tax Reduction Act of 1965
8. Social Security Act of 1965

Handout No. 1

AUDITED RETURNS ARE CHECKED FOR—

1. Method of handling income
2. Larger items of expense
3. Journal entries
4. Minutes books of directors' meetings (corporations)
5. Travel and entertainment expenses
6. Inventory records



This page and the following illustrate a two-fold leaflet which summarizes the subject presentation. The leaflet is available in quantity from the nearest Small Business Administration office for distribution to participants in SBA-cosponsored administrative management courses.

HOW DO YOU HANDLE—

1. Ordinary and necessary business expenses
2. Travel and entertainment
3. Capital expenditures
4. Depreciation
5. Investment credit
6. Inventories
7. Installment sales

TYPES OF DEPRECIATION

- Straight line
- Declining balance
- Sum of the years-digits

FIVE TYPES OF INVENTORIES

1. Merchandise, or stock in trade
2. Raw materials
3. Work in progress
4. Finished products
5. Supplies

ESTATE AND GIFT TAX DEDUCTIONS

1. Nontaxable gifts
2. Specific exemption—$30,000
3. Charitable deduction
4. Marital deduction

EMPLOYMENT TAXES

1. Social Security
2. Unemployment
3. Federal income withholding
4. Corresponding State and local taxes

EXCISE TAXES IMPOSED ON—

1. Sales of some items
2. Use of some items
3. Certain transactions
4. Certain occupations

A TYPICAL TAX CALENDAR

> This tax calendar was issued by IRS for 1966. The calendar for the current year may be found in the latest edition of TAX GUIDE FOR SMALL BUSINESS.

On or before the dates listed below, you should take the action indicated. Saturdays, Sundays, and legal holidays have been taken into account. If you file your income tax return on the basis of a fiscal year, you should make the changes described at the end of this Calendar.

JANUARY

During the Month you may deposit income tax withheld and employer and employee social security taxes (Form 450), and excise taxes (Form 537)—regardless of amounts withheld or collected—for December 1965, and gain an extension of time in which to file quarterly returns for such taxes, provided such taxes for October 1965 and November 1965 were timely deposited. See February 10. Also see Chapters 27 and 29.

A Corporation which meets certain requirements discussed in Chapter 32 may elect, at any time during the month, not to be taxed as a corporation for the year 1966.

Employers should give their employees Copy "B" and Copy "C" of Form W-2 as soon as possible. See January 31.

Dealers (wholesaler, jobber, distributor, or retailer) must, before this date, have made a request of manufacturers, producers, or importers in connection with their inventories of goods on hand June 22, 1965, which are eligible for floor stock refunds due to excise tax cuts effective on that date.

JANUARY 17

Individuals must pay the balance due on their 1965 estimated income tax, or in lieu thereof, file an individual income tax return (Form 1040) on or before January 31 and pay the full amount of the tax due for 1965. See January 31.

Farmers and Fishermen may elect to file declaration of estimated income tax (Form 1040-ES) for 1965 and pay estimated tax in full, and file 1965 income tax return (Form 1040) by April 15. If declaration of estimated tax is not filed, see February 15.

JANUARY 31

Individuals should file an income tax return for 1965 and pay the tax due, if the balance due on their 1965 estimated income tax was not paid by January 17. Use Form 1040. Farmers and fishermen, see February 15.

Employers give every employee Copy "B" and Copy "C" of Form W-2 showing the income and social security information.

Employers of 4 or more individuals on at least 1 day of each of 20 weeks in 1965 must file a return and pay the Federal Unemployment tax. Use Form 940.

Employers file Form 941 for income tax withheld and social security taxes for the 4th quarter of 1965 and pay such taxes. If taxes due were timely deposited see February 10.

Employers file reconciliation of income tax withheld from wages transmitting Forms W-2, Copy "A." Use Form W-3.

Manufacturers, Retailers, and Others file quarterly excise tax return for 4th quarter of 1965 and pay tax. If tax due was timely deposited see February 10. Use Form 720.

Payers and nominees give annual statements to recipients of dividend or certain interest payments aggregating $10 or more.

FEBRUARY 10

Manufacturers, Producers, or Importers must, on or before this date, have claimed credit or refund for floor stocks of goods held by dealers on June 22, 1965, due to excise tax cuts effective on that date, and must have either reimbursed the dealers, or have obtained their written consent to the allowance of a refund.

Extended Date for Quarterly Returns:

Employers who made timely deposits of income tax withheld and social security taxes due for the 4th quarter, 1965, file 4th quarter return. Use Form 941.

Manufacturers, Retailers, and Others who made timely deposits of all excise taxes due for the 4th quarter, 1965, file 4th quarter return. Use Form 720.

FEBRUARY 15

Employers liable for income tax withheld and social security taxes in excess of $100 for the month of January must deposit such taxes with a depositary. Use Form 450.

Farmers and Fishermen who did not elect to file declaration of estimated tax for 1965 on January 17 should file final income tax return (Form 1040) for 1965.

FEBRUARY 28

All Businesses must file annual information returns covering payments made in 1965 of salaries, wages, fees, commissions, and other compensation for personal services totaling $600 or more to the extent not reported on Form W-2. Payment of dividends and certain interest aggregating $10 or more must be shown on an information return. Also include payments of rents, royalties, annuities, pensions, and other fixed or determinable income (including interest not subject to the $10 reporting requirement) totaling $600 or more. Use Forms 1096 and 1099 or 1087.

Manufacturers, Retailers, and Others liable for more than $100 of excise taxes for January must deposit such taxes with a depositary. Use Form 537.

Unincorporated Businesses electing to be taxed as corporations for the year 1965 must file statements to that effect with the District Director for the District in which their principal place of business is located. See Chapter 32.

MARCH 15

Corporations must file a 1965 income tax return, Form 1120, or application for extension, Form 7004, and pay at least 50% of balance of tax due. See Chapter 32.

Corporations which have elected not to be taxed as corporations must file Form 1120S.

Unincorporated Businesses electing to be taxed as corporations must file their 1965 income tax returns, Form 1120, or application for extension on Form 7004, together with a payment for at least 50% of the balance of income tax due. The return must contain a statement to the effect that it is filed in accordance with section 1361 of the Internal Revenue Code. See Chapter 32.

Employers liable for income tax withheld and social security taxes in excess of $100 for the month of February must deposit such taxes with a depositary. Use Form 450.

MARCH 31

Manufacturers, Retailers, and Others liable for more than $100 of excise taxes for February must deposit such taxes with a depositary. Use Form 537.

APRIL

During the Month you may deposit income tax withheld and employer and employee social security taxes (Form 450), and excise taxes (Form 537)—regardless of amounts withheld or collected—for March, and gain an extension of time in which to file quarterly returns for such taxes, provided such taxes for January and February were timely deposited. See May 10. Also see Chapters 27 and 29.

APRIL 15

Individuals must file an income tax return for the calendar year 1965. The tax due must be paid in full with the return when filed. With this return, Schedule "C" must be filed, and in addition Schedule "SE" must be completed in order that you may receive proper social security credit for self-employment income. Use Form 1040.

Individuals must file a declaration of estimated income tax for 1966, and pay at least 25% of such tax. Use Form 1040-ES.

Partnerships must file a return of income for the year 1965. Use Form 1065.

Corporations must file 1966 declaration of estimated income tax and pay 1st installment of 9% of such tax. Use Form 1120-ES. See Chapter 32.

MAY 2

Employers file Form 941 for income tax withheld and social security taxes for the 1st quarter and pay such taxes. If the taxes due were timely deposited see May 10.

Manufacturers, Retailers, and Others file quarterly excise tax return for 1st quarter and pay the tax. If the tax due was timely deposited see May 10. Use Form 720.

MAY 10

Extended Date for Quarterly Returns:

Employers who made timely deposits of income tax withheld and social security taxes due for the 1st quarter, file 1st quarter return. Use Form 941.

Manufacturers, Retailers, and Others who made timely deposits of all excise taxes due for the 1st quarter, file 1st quarter return. Use Form 720.

MAY 16

Employers liable for income tax withheld and social security taxes in excess of $100 for the month of April must deposit such taxes with a depositary. Use Form 450.

MAY 31

Manufacturers, Retailers, and Others liable for more than $100 of excise taxes for April must deposit such taxes with a depositary. Use Form 537.

JUNE 15

Individuals must pay 2d installment of 1966 estimated income tax.

Corporations must pay the balance of 1965 income tax liability. 2d installment of 9% of 1966 estimated income tax liability is due. See Chapter 32.

Employers liable for income tax withheld and social security taxes in excess of $100 for the month of May must deposit such taxes with a depositary. Use Form 450.

JUNE 30

Manufacturers, Retailers, and Others liable for more than $100 of

excise taxes for May must deposit such taxes with a depositary. Use Form 537.

Dealers must, on or before this date, have made a request of manufacturers, producers, or importers in connection with their inventories of goods on hand January 1, 1966, which are eligible for floor stock refunds due to excise tax cuts effective on that date.

JULY

During the Month you may deposit income tax withheld and employer and employee social security taxes (Form 450), and excise taxes (Form 537)—regardless of amounts withheld or collected—for June, and gain an extension of time in which to file quarterly returns for such taxes, provided such taxes for April and May were timely deposited. See August 10. Also see Chapters 27 and 29.

JULY 1

Persons manufacturing, maintaining for use, or dealing in or with the businesses or products listed below, if they are currently registered, must, on or before this date, register and pay for occupational tax stamps for the new fiscal year ending June 30, 1967. Persons who will engage in business for the first time must register and pay for occupational tax stamps **before** commencing business in connection with any of the following:

Gaming devices	Use Form 11-B
Wagering	Use Form 11-C
Narcotics or marihuana	Use Form 678
Brewing beer	Use Form 11
Rectifying distilled spirits or wines	Use Form 11
Selling distilled spirits, beer, or wines	Use Form 11
Manufacturing stills or condensers for distilling spirits	Use Form 11
Firearms	Use Form 11

AUGUST 1

All Businesses must register and pay for occupational tax stamps for the fiscal year ending June 30, 1967, provided they maintain for use or deal in or with:

Adulterated and process or renovated butter	Use Form 11
Filled cheese	Use Form 11

Employers file Form 941 for income tax withheld and social security taxes for the 2d quarter and pay such taxes. If the taxes due were timely deposited see August 10.

Manufacturers, Retailers, and Others file quarterly excise tax return for the 2d quarter and pay the tax. If the tax due was timely deposited see August 10. Use Form 720.

AUGUST 10

Manufacturers, Producers, or Importers must, on or before this date, have claimed credit or refund for floor stocks of goods held by dealers on January 1, 1966, due to excise tax cuts effective on that date, and must have either reimbursed the dealers, or have obtained their written consent to the allowance of a refund.

Extended Date for Quarterly Returns:

Employers who made timely deposits of income and social security taxes due for the 2d quarter, file 2d quarter return. Use Form 941.

Manufacturers, Retailers, and Others who made timely deposits of all excise taxes due for the 2d quarter, file 2d quarter return. Use Form 720.

AUGUST 15

Employers liable for income tax withheld and social security taxes in excess of $100 for the month of July must deposit such taxes with a depositary. Use Form 450.

AUGUST 31

Highway Vehicle Owners or Operators must pay the Federal use tax on motor vehicles used on the public highways. See Chapter 29. Use Form 2290.

Manufacturers, Retailers, and Others liable for more than $100 of excise taxes for July must deposit such taxes with a depositary. Use Form 537.

SEPTEMBER 15

Individuals must pay 3d installment of 1966 estimated income tax.

Corporations must pay 3d installment of 25% of 1966 estimated income tax. See Chapter 32.

Employers liable for income tax withheld and social security taxes in excess of $100 for the month of August must deposit such taxes with a depositary. Use Form 450.

SEPTEMBER 30

Manufacturers, Retailers, and Others liable for more than $100 of excise taxes for August must deposit such taxes with a depositary. Use Form 537.

OCTOBER

During the Month you may deposit income tax withheld and employer and employee social security taxes (Form 450), and excise taxes (Form 537)—regardless of amounts withheld or collected—for September, and gain an extension of time in which to file quarterly returns for such taxes, provided such taxes for July and August were timely deposited. See November 10. Also see Chapters 27 and 29.

OCTOBER 31

Employers file Form 941 for income tax withheld and social security taxes for the 3d quarter and pay such taxes. If the taxes due were timely deposited see November 10

Manufacturers, Retailers, and Others file quarterly excise tax return for the 3d quarter and pay the tax. If the tax due was timely deposited see November 10. Use Form 720.

NOVEMBER

Employers should request the filing of a new Form W-4 by each employee whose withholding exemptions will be different in 1967 from the exemptions claimed on the last certificate.

NOVEMBER 10

Extended Date for Quarterly Returns:

Employers who made timely deposits of income and social security taxes due for the 3d quarter, file 3d quarter return. Use Form 941.

Manufacturers, Retailers, and Others who made timely deposits of all excise taxes due for the 3d quarter, file 3d quarter return. Use Form 720.

NOVEMBER 15

Employers liable for income tax withheld and social security taxes in excess of $100 for the month of October must deposit such taxes with a depositary. Use Form 450.

NOVEMBER 30

Manufacturers, Retailers, and Others liable for more than $100 of excise taxes for October must deposit such taxes with a depositary. Use Form 537.

DECEMBER

A Corporation which meets certain requirements discussed in Chapter 32 may elect, at any time during the month, not to be taxed as a corporation for the year 1967.

DECEMBER 15

Corporations must pay 4th installment of 25% of 1966 estimated income tax. See Chapter 32.

Employers liable for income tax withheld and social security taxes in excess of $100 for the month of November must deposit such taxes with a depositary. Use Form 450.

JANUARY 3, 1967

Manufacturers, Retailers, and Others liable for more than $100 of excise taxes for November must deposit such taxes with a depositary. Use Form 537.

FISCAL YEAR TAXPAYERS

The Due Dates in the Tax Calendar above apply to all taxpayers whether they use a calendar or fiscal year except for the following items:

Individuals—If you use a fiscal year, change the dates above for your income tax return and declaration of estimated income tax to the dates corresponding to the following:

Form 1040 is due on or before the 15th day of the 4th month following the close of your tax year.

Form 1040-ES for your current tax year is due on or before the 15th day of the 4th month following the close of your last tax year. Payment of the estimated tax is to be made in 4 equal installments due on or before the 15th day of the 4th, 6th, and 9th months of your current tax year and of the 1st month of your next succeeding tax year.

Partnerships—If you use a fiscal year, change the due date of your return of income (Form 1065) to the 15th day of the 4th month following the close of your tax year.

Unincorporated Businesses electing to be taxed as corporations must make such election not later than 60 days after the close of their tax year.

Corporations—If you use a fiscal year, change the dates above for your income tax return and declaration of estimated income tax to the dates corresponding to the following:

Form 1120 (or Form 7004) is due on or before the 15th day of the 3d month following the close of your tax year.

Form 1120-ES for your current tax year is due on or before the 15th day of the 4th, 6th, 9th, or 12th month of your current tax year, depending on when you first meet the requirements for filing. See Chapter 32.

Corporations Electing Not To Be Taxed as corporations must make election as explained in Chapter 32.

Form 1120S is due on or before the 15th day of the 3d month following the close of the corporation's tax year.

Due Date on Saturday, Sunday, or Holiday—If the due date for filing a return or making a tax payment, etc., falls on a Saturday, Sunday, or legal holiday, you may perform the act on the next succeeding day which is not a Saturday, Sunday, or legal holiday.

CHECK LIST Some of the Federal taxes for which a sole proprietor, a partnership, or a corporation may be liable are listed below.

IF YOU:	YOU MAY BE LIABLE FOR:	YOU SHOULD USE FORM:
Do business as a:		
(1) Corporation	Income tax Estimated tax	1120 1120-ES
(2) Corporation electing not to be taxed	Information return	1120-S
(3) Partnership	Information return	1065
(4) Sole proprietor (or partner)	Income tax Estimated tax Self-employment tax	1040 1040-ES 1040
(5) Unincorporated business electing to be taxed as a corporation	Income tax Estimated tax	1120 1120-ES
(6) Unincorporated trust or association	Income Tax	1120
Employ:		
1 or more persons	Income tax withholding FICA taxes	941 941
4 or more persons	FUTA tax	940
Furnish facilities for:		
Local and toll telephone service and teletypewriter exchange service Transportation of persons by air	Excise tax on facilities	720
Import:		
Adulterated or process butter	Stamp tax	923
Filled cheese	Stamp tax	923
Firearms	Occupational tax	11A
Narcotic drugs	Occupational tax Stamp tax	8;0 786
Marihuana	Occupational tax Stamp tax	960 678
Issue:		
Insurance policies (if you are a foreign insurer)	Stamp tax	427
Maintain for use:		
Slot machines	Occupational tax	11-B
Punchboards	Occupational tax Wagering tax	11-C 730
Manufacture or rebuild:		
Adulterated or process butter	Occupational tax Stamp tax	11 218
Automobiles, trucks, buses or trailers	Manufacturers excise tax	720
Beer	Excise tax	2034
Cigars, cigarettes, cigarette papers or tubes	Excise tax	2137, 3071
Distilled spirits	Excise tax	2521, 2522, 2523, 2527
Filled cheese	Occupational tax Stamp tax	11 218
Firearms	Occupational tax Manufacturers excise tax	11 720
Fishing equipment	Manufacturers excise tax	720
Narcotic drugs	Occupational tax Stamp tax	678 786
Marihuana	Occupational tax	678
Parts and accessories for trucks or buses Petroleum products	Manufacturers excise tax	720
Rectified spirits	Occupational tax	11
Stills or condensers for use in distilling distilled spirits	Occupational tax	11
Sugar Tires and tubes	Manufacturers excise tax	720
Wine	Excise tax	2050, 2052, 2523, 2527
White phosphorus matches	Stamp tax	720
Operate a:		
Brewery	Occupational tax	11
Truck, truck tractor, or bus on a highway	Federal use tax	2290
Wagering pool, lottery, or otherwise accept wagers	Occupational tax Wagering tax	11-C 730
Wholesale liquor dealership	Occupational tax	11
Sell at retail:		
Adulterated butter	Occupational tax	11
Diesel and special fuels	Retailers excise tax	720
Distilled spirits, wines, or beer	Occupational tax	11
Filled cheese	Occupational tax	11
Marihuana	Occupational tax Stamp tax	961 786
Narcotic drugs	Occupational tax	678
Transfer:		
Firearms	Stamp tax	4 (Firearms)
Marihuana	Occupational tax Stamp tax	678 786
Narcotic drugs	Occupational tax	678

SMALL BUSINESS ADMINISTRATION
U. S. Government Agency

Management
Research Summary

TAX COMPLIANCE COSTS IN SMALL FIRMS

By *Fred J. Mueller*, Associate Professor of Accounting and Finance
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HIGHLIGHTS

Businesses in all but 4 of 38 States having sales, use, and gross-receipts taxes serve essentially as tax-collection agents for the tax authority--in the majority of cases without reimbursement for the costs incurred.

About two-thirds of the 34 States levying income taxes require withholding by the employer.

Very few of the firms surveyed had any idea of the time or cost involved in tax-compliance activities.

Compliance by the study firms with regulations covering Federal payroll taxes required an average of 9.3 hours per employee per year. Collection of sales taxes from the customer required an average of 20 seconds a transaction; recording, reporting, and remitting, a total of 8.1 hours per year. These times do not include any allowance for normal corrections and interruptions.

Many small-business owners feel that taxes work a particular hardship on them. Yet they are, in most instances, subject to the same taxes and at the same rates as the larger businesses. Therefore, if there is any basis for a claim of inequity, it must lie in areas other than the taxes themselves. The heart of the problem, according to the report, is the general lack of knowledge about taxes and inability to cope with them effectively.

In addition to the taxes levied directly against the firm, there are taxes that must be collected from customers and employees. Information returns must be prepared on taxable income paid by the firm to others. It is generally recognized that these requirements impose costs on the firm, but the full extent of the costs is not known.

The study reported in this Summary had these objectives:

1. To determine the nature of the taxes small firms are required to collect.
2. To isolate activities of the firm directly related to the collection, accounting, reporting, and payment of these taxes.
3. To obtain recognition of the costs of compliance with tax requirements.
4. To reach some conclusions about ways of controlling the costs and reducing the uncertainty and risk involved.

INCOME TAXES

The Federal Government requires withholding of income and social-security taxes from all wages paid to employees--with different rules as to what is taxable income for each of the two purposes. In addition, at the time of the study, 34 States and the District of Columbia levied income taxes. Withholding is required by 23 of these States, and almost all require the reporting of amounts paid to others as interest, dividends, or rent.

AVAILABILITY OF THE FULL REPORT

Copies of the full report, entitled "The Burden of Compliance: A Study of the Nature and Costs of Tax Collection by the Small Business Firm," may be purchased for $2.50 from B. A. Faculty Publications, University of Washington, Seattle, Washington. Make checks payable to the University of Washington.

This report was prepared under the Small Business Management Research Grant Program of SBA. It may be reviewed at any SBA field office or at certain libraries whose addresses may be obtained from the SBA field offices or from the Small Business Administration, Washington, D.C. 20416.

Interpretations of what constitutes taxable new income vary, however, even among the States that base their tax on the Federal tax return. And for many small firms, interpretation and collection are further complicated by municipal income taxes.

STATE SALES-USE TAXES

Perhaps the most outstanding development in the field of taxation has been the increase in the number of jurisdictions levying sales, use, and gross-receipts taxes. By 1962, thirty-eight States and the District of Columbia imposed such taxes. In all but four of these States, the businesses serve essentially as tax-collection agents for the tax authority--in the majority of cases, without reimbursement for the costs incurred. Hundreds of cities and counties also require firms to collect sales-use taxes.

INTERSTATE COMMERCE

Small firms doing business across State lines subject themselves to a number of costs and risks. Such costs include income taxes, the costs of allocating income to the various States in which sales are made, and the costs of collecting and remitting the sales and use taxes.

Supreme Court decisions have indicated that interstate commerce must pay its fair share of local taxation provided the taxes are nondiscriminatory. Therefore, the States have been aggressively pursuing the taxes on income earned within their borders by out-of-State vendors.

TAXES OF THREE SELECTED STATES

To illustrate the scope of State and local taxes, the full report describes the tax requirements, administration, and penalties of the States of Washington, California, and Oregon. These States were selected as examples of (1) a State employing the sales-use tax as the chief source of revenue (Washington); (2) a State using both income and sales-use taxes (California); and (3) a State relying principally on the income tax (Oregon).

The report describes the tax structures of each of the three States in some detail; but for answers to specific questions, it recommends that the taxpayer consult the tax statutes and rulings of the State in which he is interested.

THE FIELD STUDY

A field study was conducted to examine the costs of men, machines, and materials devoted to the collection, withholding, and reporting of taxes and income for which others are liable. The examination was limited to expenses incurred only to comply with tax laws--over and above the necessary expenses of doing business.

One hundred and ninety-eight small businesses in the State of Washington provided the information on which cost computations were based, and the practices of 75 firms were examined in detail. Findings of the field study include those mentioned below.

THE FIRMS

- In 120 of the 198 firms, the books were kept by the owner, a member of his family, or an employee; in 78 firms, by a public bookkeeper or accountant. One hundred and twenty firms said that the records were kept primarily for tax purposes.

- Public accountants prepared all tax returns for 102 firms. A majority of the remaining firms used consulting services for tax advice and for preparing Federal income-tax returns. More than half said they would not employ public accountants if it were not for tax requirements.

- All the firms prepared financial statements, but more than half did not use the statements in the operation of the business. The most common use was for credit purposes. Many of the respondents were not sure how accounting records and statements could be used to help them in their operations.

- Observation of payroll practices showed wide variations in procedures followed. Some firms kept all employee records in a single register. A larger number used separate pay records for each employee.

Nearly all the firms maintained cumulative totals for each employee in order to determine the cutoff points for Federal Unemployment Insurance ($3,000) and Social Security ($4,800). However, many overcharged themselves on payroll taxes through errors in the computation of cumulative pay or by withholding and paying Social Security and F.U.I. beyond the cutoff points.

- Two out of three firms made sales destined for resale. All reported that exemption certificates were requested and obtained. Most of the firms did not question

the ultimate use of goods purchased but accepted the exemption certificate as their authority not to charge tax.

• Very few of the firms had any idea of the time or cost involved in tax-compliance activities, though the general feeling was that it was "too much." Those employing public accountants considered the cost for those services the total cost of tax compliance.

• The study found a general lack of knowledge on the part of the small businessman of his tax responsibilities and liabilities. This was due in part to the complexity of State and local tax structures. To a great extent, however, it was due to unwillingness or reluctance to make an effort to become informed about tax matters. Little evidence was found of organized planning to meet tax problems.

• The average small businessman, according to the study, is uncertain of the tax impact of a decision to do business across State lines. Lack of uniformity in tax requirements of the various States makes it difficult to know when taxes must be collected or withheld for other States, what transactions are taxable, when registration is required, and the possible consequences of noncompliance.

• In seeking tax help, the small businessman has often made a poor choice of public bookkeeper or tax adviser. Sometimes, this was the result of trying to get a bargain by using the cheapest source. Often it was a case of not knowing where to get competent help.

THE COSTS OF COMPLIANCE

• In general, the requirements of the sales tax are more complex from the point-of-view of compliance than those of the income tax; and there are more variations as to taxable transactions, tax liabilities, and taxable persons. Almost continual changes in the requirements make a constant reappraisal of techniques of collection and remittance necessary.

• Compliance by the study firms with regulations covering Federal payroll taxes required an average of 9.3 hours per employee per year. Collection of sales taxes from the customer required an average of 20 seconds a transaction; and the time needed to record, report, and remit these taxes totaled 8.1 hours per year. These times did not include any allowance for normal corrections and interruptions, which could increase the totals by as much as a third.

For a State of Washington firm with 10 employees, bookkeeping wages of $2 an hour, 50,000 transactions a year, and an average sale of $2, the annual costs of withholding, recording, reporting, and remitting the taxes would come to about $850.

• There appears to be a lower limit below which compliance costs are not reduced by the smallness of the firm. In fact, costs per dollar of sales or per employee were higher for the smaller firms than for the larger ones. It costs as much to prepare a tax return with a tax liability of $10 as one with a liability of $500, and the smaller firm has a smaller volume of sales over which to spread the cost.

• In addition to the direct costs of compliance, there are many indirect costs. These include the costs of tax absorption (when, for example, a sales tax cannot be shifted to the consumer, as in a business operating near the border of a State that does not impose a sales tax); additional equipment and space requirements; the inconvenience of overlapping examinations of books and records by the various taxing authorities; and so on.

• The requirement that the businessman withhold and collect taxes exposes him to the risk of penalty for failure to comply. The penalty may be assessed against a corporate official whether or not he was assigned the specific duty of overseeing the withholding and collecting and paying of the taxes. And even if the official is not penalized, he may be greatly inconvenienced by voluminous correspondence, appearances before tax commissions, and contesting tax suits in the courts.

OTHER PROBLEMS

• A major problem for small firms is the capability of the personnel available for bookkeeping and tax duties. These duties are generally performed by the overworked owner, a member of his household, or a part-time bookkeeper with little or no formal training for the work. To solve the problem, the small businessman often turns to a public bookkeeper.

• Inadequate use of accounting is a great weakness of many small firms. Few of them have accounting systems designed especially for their own needs or one that

provides all the tax information needed. The result is often overpayment of taxes.

- Unawareness of the ways accounting information can be used to improve operations and guide business decisions was widespread. In general, statements were produced solely to satisfy governmental regulations and creditors' demands. They were seldom used to help the small businessman control his affairs more efficiently.

CONCLUSIONS

From the standpoint of the businessman, the costs of tax compliance are sterile costs. They do nothing to help the firm achieve its basic objective, which is to use its resources to produce profits. Therefore, management should take positive steps to reduce these costs. This is accomplished by (1) actively seeking more efficient ways to collect, withhold, record, report, and remit taxes; and (2) arranging activities to minimize the cost of taxes imposed directly on the firm.

A solution to the problem appears to be possible only through a better understanding of tax requirements by the small businessman, better tax advice from his consultants, more advance tax planning, a greater appreciation of the uses of accounting, and better training of personnel.

The report also suggests that State and local governments should find ways to standardize their tax requirements in order to reduce the administrative burden on business. The high costs of compliance are not justified by the amount of the taxes collected, particularly in the small firm.

The costs shown in the report are averages and are not typical of any one company. Nevertheless, they should be useful as a standard against which the individual firm can compare its own costs. Critical appraisal of a firm's performance should disclose many ways in which the management can lessen the burden of compliance.

ABOUT THE STUDY

The field study combined the following approaches to the problem:

1. A questionnaire survey in which 198 firms responded;
2. Interviews with officials of 100 firms or their public accountants or bookkeepers;
3. A time study of 1,000 individual sales transactions; and
4. Testing of the results by submission to 25 firms and a number of certified public accountants, tax consultants, and public accountants and bookkeepers.

Tax-collection requirements for businesses were determined by a thorough study of tax literature.

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SMALL BUSINESS ADMINISTRATION
U. S. Government Agency

Management
Research Summary

THE ESTATE-TAX VALUATION PROBLEM IN FAMILY-OWNED FIRMS

By *Chelcie C. Bosland*, Eastman Professor of Political Economy
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HIGHLIGHTS

Problems of estate-tax valuation are often an important factor in sales or mergers of closely held firms.

The law requires that closely held securities be taxed at their "fair market value." Treasury regulations list many factors that must be considered, but they give no hint of the order of importance or how the factors can be translated into stock values.

In estate-tax valuation cases, the courts have shown a tendency to make decisions somewhere between the contentions of the taxpayer and the IRS.

The purpose of the study summarized here was to learn whether tax-valuation problems are an important cause of the decisions of small, closely held businesses to merge. Officers of 401 concerns cooperated in a survey designed to bring out the major reasons for their decisions to sell or merge. The following reasons were mentioned most often:

Reason for Sale or Merger	Number of Firms
Estate or gift taxes in general	252
Investment diversification, improved quality and marketability	237
Uncertainties about the valuation of stock	207
Desire for capital gains rather than current taxable income	189
Marketability of stock to avoid valuation uncertainties	177
Need for management continuity when owner dies or retires	148
Desire to be relieved of sole management responsibilities	147

These figures show clearly that the valuation issue is an important aspect of the estate-tax problems in merger motivation.

"FAIR MARKET VALUE"

The law requires that closely held securities be taxed at their "fair market value." Treasury regulations list many factors that must be considered, but they give no hint of the order of importance or how the factors can be translated into stock values.

Does the absence of a definite rule or formula result in variable and unpredictable valuations of ownership interest? To answer this and other questions, a study was made of legal cases having substantial stock-valuation issues. A few of the general conclusions reached from the analysis of these cases follow.

• From the evidence presented in the court cases, it appears, according to the report, that the Internal Revenue Service has tended to use whatever approach to "fair market value" will result in a high value and tax liability. Of course, the court cases may not be entirely representative, since extreme cases are most likely to reach the courts.

AVAILABILITY OF THE FULL REPORT

Copies of the full report, titled "Estate-Tax Valuation in the Sale or Merger of Small Firms," may be purchased for $10.00 from Simmons Boardman Publishing Corporation, 30 Church Street, New York 7, New York. Make checks payable to Simmons Boardman Publishing Corporation.

This report was prepared under the Small Business Management Research Grant Program of SBA. It may be reviewed at any SBA field office or at certain depository libraries whose addresses may be obtained from the SBA field offices or from the Small Business Administration, Washington 25, D.C.

- The cases revealed a strong tendency for the Service to rely on rules of thumb in value determination at the local level. Careful studies of actual market conditions were rarely made until the Service was called on to defend its determinations in court.

- Taxpayers frequently contended for unrealistically low valuations. Also, some cases seem to have been lost because of inadequate preparation and presentation of the taxpayers' cases.

- The courts provide an important degree of protection to the taxpayer willing to undertake the costs and risks of litigation.

- The record reveals a decided tendency of the courts to make what appear to be compromise decisions, somewhere between the contentions of the parties. This places a premium on the party that takes the extreme position.

- Legalistic procedure, rules of evidence, and the like sometimes prevent the court from considering value-making forces and getting at all the facts that might bear on a fully informed decision.

RECOMMENDATIONS

The Internal Revenue Service seems to be giving increasing attention to careful research into actual market conditions. However, the full report includes some suggestions for ensuring more equitable estate-tax valuation of closely held businesses. They include the following:

- Security valuation requires extensive knowledge, insight, and digging into the facts. Local tax agents may have neither the time nor the background for this; hence, special staffs at the local level may be needed. These should be coordinated for uniformity throughout the Nation.

- It might be desirable to segregate valuation cases in one branch of the Tax Court. Judges could then be chosen for their special knowledge and ability in handling cases of this type.

- It would also be desirable to establish an independent body of experts--a "Valuation Commission"--who could evaluate all evidence, whether presented by the parties or disclosed by its own studies. This Commission would pass on all valuation controversies, subject to court review on appeal. It would be independent of the Internal Revenue Service.

ABOUT THE STUDY

The report is based in part on information in questionnaires answered by 401 manufacturing, mining, trade, and service firms. All the firms had sold out or merged during the 5 years ending in 1959.

A second phase of the study was an examination of tax cases with substantial valuation issues tried between 1944 and 1960. The cases included 13C decisions of the U.S. Tax Court and 20 decisions of the U.S. District Courts and the Circuit Court of Appeals. Some of them are discussed at length in the full report.

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SMALL BUSINESS ADMINISTRATION

Management Aids FOR SMALL MANUFACTURERS

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Woshington, D.C.

RETIREMENT PLANS FOR SMALL BUSINESS

By *Morton R. Gould*
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SUMMARY

Small businessmen are finding a growing interest in retirement plans. This interest is growing because the United States population is living longer, because of business competition and because of the personal and business advantages to be gained through the use of such plans.

Many factors are involved in starting and maintaining a retirement program. One is cost. The type of program--what kind of benefits the small businessman wants and how he will finance them--is among the main elements determining how much a retirement plan will cost--now and in the future.

This Aid discusses the types of plans that can be used, pointing out the general advantages and disadvantages of each. The small businessman will, of course, want to discuss such a prospective program with a qualified specialist, such as his lawyer, insurance advisor, pension consultant, financial advisor, and accountant.

Many small businessmen want to provide retirement benefits for their employees. These owner-managers are sometimes painfully aware of some of the disadvantages of not having retirement programs--as when one of their bright young workers takes a job with a competitor who offers retirement benefits.

"But retirement programs are too expensive for small companies," many small businessmen tell themselves and their friends.

George Sonsun (name disguised) who has 20 employees is one of them. He found that his company, however, could afford a retirement program.

He started a Deferred Pension Plan that costs far less than he had imagined. The details of it are shown in the table at the bottom of page 2.

Another owner-manager, Roger Mallory, (name disguised), whose company is similar to Mr. Sonsun's, uses a Deferred Profit Sharing Plan. Details of how it works are shown in the table at the top of page 3.

Tax advantages help these companies to have retirement programs. Those advantages are: (1) An employer's contributions to a retirement plan are tax deductible (Deductions are limited by Section 404 of the Internal Revenue Code.); (2) A retirement trust fund is tax exempt (its earnings are too); (3) Employees need not include in their gross income the funds the company puts into their retirement program; (4) At retirement age they may get preferential tax treatment.

To gain these advantages a company has to set up a qualified plan.

WHAT IS A QUALIFIED RETIREMENT PLAN?

"Qualified" means the retirement plan has been approved by the Internal Revenue Service for certain tax advantages. An IRS determination that a plan is qualified is known as a determination letter. Such a ruling is not essential to qualification. Actual compliance is enough. Pension advisers are familiar with problem areas. A qualified plan sets up a nonreversionary trust.

The employee draws retirement income from this trust fund. To be eligible for a qualified retirement plan, your company must meet certain requirements. They are: (1) Your plan must be for the exclusive benefit of the employees or their beneficiaries, (2) Your plan may not discriminate in favor of employee-stockholders or other highly-paid supervisory workers, (3) The funds you contribute may never revert to the company, (4) Your plan must be in writing and your employees must know about it, (5) You must intend for the plan to be permanent.

TYPES OF RETIREMENT PLANS

As has been suggested already, you can use either (1) The Deferred Pension Plan, or (2) The Deferred Profit Sharing Plan. Or (3) you might use a combination of the two.

These plans give the employee retirement income in addition to his Social Security benefits. Your tax advantages, as a rule, are about the same in either plan.

Still another plan is the Individual Deferred Compensation Plan, but it is not a qualified

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plan. It allows you to be highly selective in the choice of the employees to be covered. For further information see: *Management Aid* No. 107, "Using Deferred Compensation in Small Business," Small Business Administration, Washington 25, D. C. 1959. Free)

• Deferred Pension Plan

This plan guarantees the employee a known benefit when he retires. Your annual contribution to the trust depends on the amount of money needed to build up funds to provide this known benefit.

For example, how much money will you have to set aside in the next 35 years to give a 30-year-old employee a lifetime monthly retirement check of $60? This type plan allows you to take care of both young and older employees. Under it you can build the necessary retirement fund in a relatively short time for your older employees.

Usually you determine the retirement benefits with a formula. It can be based on a percentage of the employee's salary (present and future). It can be a flat sum based on years of service. Or it can be a combination of the two. In any event whatever formula used applies to all participants under the plan.

Some companies allow the employee to contribute to the fund also. His contribution usually runs from 1 percent to 5 percent of his wages.

• Deferred Profit Sharing Plan.

This plan gets its funds from the company's profits. Each year a certain amount of the profits go into the profit sharing fund. This amount may vary from year to year or you can set it according to a formula.

Usually an employee's stake in profit sharing is based on his salary range. In the Deferred Profit Sharing Plan, the employee gets his profits at retirement age. You invest his share of the profits each year to build the retirement fund.

This plan does not guarantee the employee any certain amount of dollars in his monthly retirement check.

A Deferred Profit Sharing Plan, as a rule, can do little toward providing substantial retirement income to older employees. However, for young employees this plan may be as good as a Deferred Pension Plan.

HOW DO YOU FINANCE IT?

You have to set up a retirement trust fund whether you use the Deferred Pension Plan (The trust in some group annuity pension plans is handled by the insurance carrier.) or the Deferred Profit Sharing Plan. This trust fund receives your contributions, invests them, and pays the retirement benefits. Remember, its earnings are tax free as long as they are plowed back into the trust fund.

You can finance your retirement trust fund in various ways. The three most widely used ways are: (1) a wholly insured plan, (2) an uninsured plan, and (3) a combination plan.

In the insured plan, you buy any one of several forms of retirement income insurance. At retirement age the insuring company will pay the required benefit. In most cases it will also relieve you of most of the administrative burdens. One advantage is that the insurance company guarantees the solvency of the retirement fund. In other words, once you have paid the premium, your responsibility for the payment of benefits is ended.

SONSUN COMPANY'S DEFERRED PENSION PLAN

Sonsun Company (name disguised) with 20 employees uses a "qualified" Deferred Pension Plan. This retirement plan started with 8 eligible employees, including Mr. Sonsun, the owner-manager, and two stockholders. Sonsun's plan uses a formula that will give each employee a monthly retirement check for life. This check will be equal to 1 percent of the employee's average monthly salary multiplied by his years of service at age 65. Sonsun is financing its Deferred Pension Plan by a split-fund (a combination of the insured financing method and the uninsured method--see page 2). The table below shows how both employees and Sonsun Company benefit from the Deferred Pension Plan.

Sex & Age	Monthly Salary	Total Service at age 65		1 Percent of Salary		Monthly Retirement Check	Insurance Coverage*	Sonsun's 1st Year Contribution
Male-32	$ 390	38 years	×	$ 3.90	=	$148	$14,820	$ 534.11
Female-30	250	38 years	×	2.50	=	95	9,500	334.22
Male-34	400	37 years	×	4.00	=	148	14,820	581.79
Female-37	350	34 years	×	3.50	=	119	11,900	561.92
Female-40	400	37 years	×	4.00	=	148	14,800	812.37
Male-35-S	400	37 years	×	4.00	=	148	14,800	608.43
Male-40-S	1,000	32 years	×	10.00	=	320	32,000	1,672.00
Male-45-S	1,500	38 years	×	15.00	=	570	57,000	3,932.43
								$9,037.27

*Optional   S-Stockholder

Summary of Costs:

Gross 1st Year Contribution	$9,037.27
1st Year Dividends on Insurance Policies	509.22#
Net before taxes	$8,528.05
Net after taxes if Sonsun is in 30 percent tax bracket	$5,969.64
Net after taxes if Sonsun is in 52 percent tax bracket	4,093.46

#Dividends are based on 1961 scale and are not guarantees or estimates for the future.

MALLORY PRODUCTS' DEFERRED PROFIT SHARING PLAN

Mallory Products (name disguised) with 20 employees uses a "qualified" Deferred Profit Sharing Plan. This retirement plan started with 8 eligible employees, including Owner-Manager Mallory and one stockholder. Mr. Mallory's plan does not guarantee an exact amount at retirement because the funds for his plan come from the company's annual profits. He and his employees cannot know how much the retirement trust fund will contain 30 or 35 years from now. However, the table below indicates how Mallory Products' Deferred Profit Sharing Plan would look when the youngest employee retires in 35 years IF: (1) employees' salaries stay the same and (2) the company continues to put in the maximum deductible contribution each year.

Sex & Age	Annual Salary	Insurance Coverage*	Maximum Deductible Amount (15 percent annual salary)	Contribution** Invested at 4 percent to Retirement	Total value of fund to Participant#
M-32	$ 4,680	$10,222	$ 702	$32,693.	$43,945.
F-30	3,000	7,092	450	23,279.	31,439.
M-34	4,800	9,611	720	30,096.	40,222.
F-37	4,200	7,951	630	22,245.	30,064.
F-40	4,800	8,196	720	21,269.	28,699.
M-35	4,800	9,295	720	28,477.	38,047.
M-40	12,000	19,887	1,800	53,174.	71,145.
M-45	18,000	24,738	2,700	57,544.	76,558.
			$8,442.		

*Optional ** Annual contribution after payment of insurance premium.

Available as lifetime income or as lump sum. Total value of fund at retirement includes cash value of insurance plus dividends plus invested portion of fund.

Summary of costs:

Gross 1st year contribution:	$8,442.
1st year dividend on insurance policies:	285.##
Net before taxes:	$8,157.
Net after taxes if Mallory Products is in 30 percent tax bracket	$5,709.
Net after taxes if Mallory Products is in 52 percent tax bracket	3,915.

##Dividends are based on 1961 scale and are not guarantees or estimates for the future.

In an uninsured plan (or "self-insured" plan), you administer your retirement trust fund. You guarantee your employees that the money will be there when their benefits are due. The earning potential of your retirement trust fund is likely to be greater than it would be under an insurance company's conservative portfolio.

The combination plan is a middle road. Often called a split-fund plan, it combines most of the guarantees of an insured plan with the investment principle of the uninsured plan.

WHAT KINDS OF BENEFITS?

Next to the monthly retirement check, some of the other benefits you may want in your retirement plan are: • Severance benefits, • Disability benefits, and • Survivors benefits (death).

Severance benefits (or vesting) are an employee right to some part of the monies that the fund has been accumulating for him. Some employers give him all or part of what he has a vested right to. Others choose to give him nothing if he leaves prior to his normal retirement age.

Whether your firm includes severance benefits depends on the type plan you use. It must eventually be provided in a Profit Sharing plan. It is optional under a Pension plan. If your employees contribute to the plan, they will always have a right to receive their contributions back should they leave. As a practical matter it is best to start vesting within the first 5 years.

Disability benefits pay the employee if he is disabled before retirement age. Usually he gets less than if he'd stayed on. The exact sum will depend on length of service and his age.

Survivors benefits cost very little to maintain, but do a great deal for employee morale. The family of the deceased employee is guaranteed very nearly his retirement income should he die prior to normal retirement.

A benefit which does not cost you is the tax advantages your employees get at retirement. Briefly, they usually have the advantages of double exemptions and a lower income bracket. These conclusions are based on the assumption that retirement takes place at the age of 65 and when the employee has little income from other sources.

WHAT WILL IT COST?

Your retirement program should be tailored to your company. For instance, what sort of benefits do you want? How many employees are you covering? What ages and so on?

Generally speaking, the cost of your retirement program will be the actual amount necessary to retire each employee until he dies plus the cost of administering the plan, less any dividends, interest or credits earned.

Remember that you're, in a sense, buying something--retirement benefits for your employees. Think of these benefits as an offset

to human depreciation. Be aware of benefits as cost items as well as attractive features. Of course, if your employees are mostly young people your annual cost will be cheaper than if the majority is in late middle age. The reason: The younger the group, the longer time you have to create the retirement fund.

Other guidelines that may be helpful when you're trying to determine cost figures are:

(1) Ask your consultant for cost estimates based on 20 or 30 year projections.

(2) See that you are offered a choice of funding methods to choose from.

(3) See that the analysis of your method of financing is backed up by an actuarial statement. Even a small error in calculation can develop into a sizeable dollar drain over the years.

(4) Know what your maximum contribution will be and under what assumptions.

(5) Know what your minimum contribution will be and under what assumptions.

(6) Watch out for contribution inflexibility. Even though a Deferred Pension Plan may set a supposedly "fixed" annual contribution, your plan should allow you the privilege of a smaller annual contribution. This arrangement allows you to protect your business in lean or no profit years.

(7) If you have to suspend your annual contribution to a Pension plan because of "business necessity," remember that sooner or later you'll have to make larger annual contributions to keep the retirement trust fund up.

(8) While your annual contribution in a Deferred Profit Sharing Plan is no fixed amount of dollars, watch out for debts against the retirement trust fund. In some cases you or the trust will have to pay up even if your company has no profits that year.

GETTING STARTED

One of your first steps in getting a retirement program started is to see a competent pension plan specialist, such as your lawyer, insurance advisor, accountant or a consultant who specializes in retirement finances. These experts can help you to find answers to questions, such as:

(1) Do I have the dollar capability?

(2) What benefits do I want to provide and under what circumstances?

(3) Do I want to provide benefits for all employees, or particular classes of employees?

(4) Which plan will best suit my company?

(5) What method of financing will I use?

(6) How much flexibility will I have in my annual contributions to the plan?

FOR FURTHER INFORMATION

Readers may wish to consult the following references for additional study. The list is necessarily brief and selective. However, no slight is intended towards authors whose works are not mentioned.

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Filing Classification:	*Personnel Management*

CASES IN POINT

Case Studies for Depth Penetration

Section

The case method has proven stimulative and effective in many administrative management courses. The following case material is suggested as a means of encouraging discussion.

It is suggested that one full session be devoted to the presentation of the topic as outlined in this manual. A case can sometimes be used to stimulate or augment the discussion period that follows the presentation. This could be one way of expanding the basic materials into an advanced course on the subject.

THE CASE METHOD OF STUDY

The case method is a teaching device that helps the student learn through the processes of reasoning and decision making. Other popular teaching techniques stress learning or memorizing other people's knowledge on a given subject. The case method stresses his thinking abilities rather than his memory; it is dynamic, not passive.

What is a case? It is a description of an actual or true-to-life business situation. It is a statement of facts, opinions, and judgments--in short, a problem having no pat answer but lending itself to discussion and analysis.

The case method is particularly helpful in teaching businessmen because it uses real, practical problems rather than abstract situations. Properly used, it involves the participants in a way that will hold their interest and stimulate their thinking. It is particularly useful in developing in the individual (1) the ability to make decisions on administrative tasks (without incurring the penalties of a wrong decision on the job); and (2) the habit of thinking analytically and constructively.

The case method also highlights the value of group discussion and analysis. Each member of the group contributes from his unique experience, and each participant gains from the others. The group's knowledge and experience will exceed that of any one participant--including the instructor.

The following checklist can serve as a procedure for conducting case study and analysis:

Suggestions for Case Study

1. Read the case carefully for general content.
2. Arrange the facts of the case in order of importance.
3. Recognize and define the major problem(s) needing solution.
4. Analyze the problems and their relative importance.
5. Search for and establish alternative solutions.
6. Select the most desirable of the appropriate solutions.

7. Analyze your probable solutions; set up the pros and cons, giving value to each.

8. State your choice, decision, or final conclusion--and be prepared to defend it.

9. Set forth the plan you would follow to implement the decision.

EFFECTIVE TAX PLANNING IN CHANGING TO CORPORATE FORM

This case study reviews the story of a business which has used good tax planning and reflects the typical handling of taxes in a small family corporation. An important part of the discussion is that covering the comparison of taxes under alternative forms of organization.

History of the Firm

John Adams had operated his small business for several years before he decided to incorporate it in 1952. His primary reasons for incorporating were to obtain limited liability and to make it easier for the business to continue in the event of his death, thus providing an income for his widow and minor children. The business was incorporated when he wrote his will and started planning his estate.

When the business was incorporated, the stock was issued to Mr. and Mrs. Adams jointly with the right of survivorship. 2/ Since the value of the stock was under $30, 000, no gift tax was involved.

Adams kept the building in his name and rented it to the corporation. As will be seen later, this was helpful in keeping the tax as low as possible.

1/ From Income Tax Influences on Legal Form of Organization for Small Business by R. H. Raymond and Clifford M. Hicks, The University of Nebraska under the Small Business Administration Management Research Grant Program.

2/ While this method was a sound choice in this instance, there are many situations when joint ownership is not desirable. Joint ownership should not be used without first consulting an attorney who is familiar with probate procedures in the stockholder's State. Just because joint ownership is right for one person does not even mean that it is right for other members of the same firm.

The balance sheets in Table 1 show that the firm has progressed satisfactorily but that no great expansion has taken place during the period covered by this study (April 1952 to March 1960). The total investment in equipment is nearly three times the investment at the time of incorporation, indicating that the plant has been modernized and kept up-to-date. Since retained earnings have grown slowly and there are loans due to Adams, the corporation must have distributed most of the earnings. The corporation has occasionally borrowed from its stockholders rather than retain substantial earnings in the firm.

TABLE I
CONDENSED, COMPARATIVE BALANCE SHEETS

	WHEN INCORPORATED April 1, 1952		AT END OF STUDY PERIOD March 31, 1960	
Assets:				
Current assets		$ 4,750		$ 7,500
Equipment:				
Cost	$10,500		$32,500	
Portion charged to expense (depreciation)	0	10,500	17,900	14,600
Other assets		0		1,200
Total assets		$15,250		$23,300
Liabilities:				
Accounts payable & accruals		0		$ 2,500
Notes payable		$ 3,250		3,500
Total liabilities		$ 3,250		$ 6,000
Equity:				
Common stock	$12,000		$12,000	
Retained earnings	0	12,000	5,300	17,300
Total liabilities and equity		$15,250		$23,300

Condensed earnings statements for both the corporation and for Mr. and Mrs. Adams for each year are summarized in Table 2. This table also shows the tax which was paid.

The firm has distributed most of its earnings in the form of salary and rent rather than as dividends. So, the most significant part of Table 2 is the detail of Adams' income from the firm--between $9,000 and $15,000 a year.

Tax Under Alternative Forms of Organization

This firm would clearly seem to be one of those firms which Congress had in mind when it enacted Subchapter S of the Internal Revenue Code (tax-option election) for small-business corporations in 1958. The corporate form was chosen by Adams purely for business reasons.

TABLE 2

CONDENSED, COMPARATIVE STATEMENT OF EARNINGS AND TAX PAID b/

	FISCAL YEAR ENDED March 31							
Corporation:	1953	1954	1955	1956	1957	1958	1959	1960
Sales	$86,600	$81,700	$84,500	$82,700	$75,600	$79,700	$87,400	$91,400
Cost of goods sold	42,900	37,000	39,500	37,600	34,000	34,700	35,700	38,200
Gross profit	$43,700	$44,700	$45,000	$45,100	$41,600	$45,000	$51,700	$53,200
Operating expenses	43,300	43,700	43,500	43,800	41,100	44,000	49,800	51,700
Net operating profit	$ 400	$ 1,000	$ 1,500	$ 1,300	$ 500	$ 1,000	$ 1,900	$ 1,500
Other income and expense	0	0	100	200	200	100	200	160
Net profit	$ 400	$ 1,000	$ 1,600	$ 1,500	$ 700	$ 1,100	$ 2,100	$ 1,600
Corporate tax paid	$ 128	$ 300	$ 476	$ 434	$ 209	$ 344	$ 617	$ 473
	CALENDAR YEAR							
Individual:	1952	1953	1954	1955	1956	1957	1958	1959
Rent of building to firm:								
Rent charged	$ 2,462	$ 3,904	$ 3,538	$ 3,563	$ 3,297	$ 3,377	$ 3,619	$ 3,922
Expenses (inc. depreciation)	774	1,234	1,040	901	977	684	1,037	818
Net rental income	$ 1,688	$ 2,670	$ 2,498	$ 2,662	$ 2,320	$ 2,693	$ 2,582	$ 3,104
Profit from business for three months before incorporating	3,607							
Salary:								
John Adams	3,900	6,113	8,277	9,563	9,177	7,214	8,180	11,483
Mrs. Adams	75	504	403	269	448	380	494	414
Directors' fees	30	30	60	30	0	0	0	0
Interest on loan to firm	0	88	88	88	76	141	141	212
Dividends from firm (after exclusion)	0	0	195	490	195	0	0	0
Other	0	0	0	0	0	0	16	47
Adjusted gross income	$ 9,300	$ 9,405	$11,521	$13,102	$12,216	$10,428	$11,413	$15,260
Individual tax paid a/	$ 1,520	$ 1,544	$ 1,860	$ 2,257	$ 2,041	$ 1,598	$ 1,690	$ 2,785

a/ Copied directly from the owner's tax returns. Details of itemized personal deductions, exemptions and other details which are the exact figures from actual returns, and are held constant in the alternative computations, are omitted in order to help the reader concentrate on (a) data needed and (b) results. In this case, three exemptions were claimed, but itemized deductions were used some years and the standard deduction some years.

b/ Figures on the income statement are rounded to the nearest one hundred dollars. Obviously, 30% of the accounting profit rounded to the nearest hundred dollars will not give the exact corporate tax. These are separate, selected bits of information. For example the exact corporate adjusted gross income (not necessarily the accounting net profit) in 1960 was $1,578.18 and the tax was $473.45.

It would be unfortunate if this choice cost him substantial additional taxes. In order to determine the tax effect of his choice, the taxes which would have been paid under four alternative forms of organization were computed and are summarized in Table 3.

Combined individual and corporation income and tax figures, summarized from Table 2, are listed by year to permit comparison with the alternative tax computations.

TABLE 3
TAXES UNDER ALTERNATIVE FORMS OF ORGANIZATION

	ACTUAL TRANSACTIONS			TAX IN ALTERNATIVE FORMS			
						Corporation	
Year	Total Sales	Total Net Business Income a/	Total Tax Paid b/	Partnership c/	Tax-Option Corporation	Optimum Planning d/	No Planning e/
1952	$ 86,600	$ 9,700	$ 1,520	$ 1,609	$ 1,520	$ 1,520	$ 1,701
1953	81,700	10,400	1,672	1,758	1,638	1,672	2,373
1954	84,500	12,900	2,160	2,213	2,077	2,160	3,662
1955	82,700	15,900	2,735	2,485	2,566	2,735	4,645
1956	75,600	14,100	2,475	2,140	2,376	2,475	3,184
1957	79,700	12,700	1,807	1,857	1,765	1,807	2,891
1958	87,400	11,500	2,034	2,195	1,988	2,034	4,731
1959	91,400	16,800	3,258	3,237	3,402	3,258	6,723
Total	$669,600	$104,000	$17,661	$17,494	$17,332	$17,661	$29,910

a/ Includes net corporate income plus adjusted gross income of Mr. and Mrs. Adams less dividends.
b/ Figures represent total of corporate and individual taxes paid.
c/ The difference in tax between the partnership and the tax option form is due in part to the inclusion of the income of the corporate fiscal year in the partnership earnings. See note 1 below.
d/ Same as tax actually paid since the firm was striving for optimum tax planning. Details of bonuses, interest, dividends, etc., can be ascertained from Table 2.
e/ Assumptions:

1. Building was contributed to corporation along with rest of the assets in return for stock.
2. A flat salary of $500 a month was drawn.
3. The same cash withdrawals as in the actual operation are assumed except that all over $500 now becomes dividends.

Partnership

The first alternative is the partnership form. Since Mr. and Mrs. Adams file joint returns, the tax in the partnership form is the same as it would have been had the firm continued as a proprietorship

and would have totaled $17,494 for the years included in this study. 3/ Since a total of $17,661 was actually paid, the corporate form cost Adams the difference between these amounts, or $167 of tax, over the eight-year period. In his mind, the business advantages of the corporate form were worth this cost.

Tax-Option Corporation

The partnership-like tax option election under Subchapter S was not available during most of this period. However, the taxes under this election are shown in Table 3. The tax would have been about the same as in the partnership or proprietorship form, and Adams also would have had the business advantages of the corporate form.

Conventional Corporation with Optimum Tax Planning

The term "optimum tax planning," as used here, means arranging the affairs of the corporation in such a way as to reduce the tax to the lowest possible amount over a period of years without violating the law or the spirit of the law.

The next to the last column in Table 3 tabulates the tax which would have been paid under optimum tax planning. It is apparent that Adams was successful in optimum tax planning, as the tax reflected in this column is the same as the tax actually paid. Reference to Table 2 will show that most of the income of the corporation was distributed each year, but that some income was left in the corporation. The firm used three methods to get income out of the corporation without the double tax which would apply to dividends: (1) Adams was paid a bonus each year based on a percentage of corporate profits, (2) the building was retained by Adams and was rented to the corporation for a percent of gross receipts and (3) Adams occasionally loaned money to the firm and interest was paid on those loans.

3/ Since the corporation is on a fiscal year ending March 31, there are three months of extra income of the corporation included. However, since most of the corporate income is withdrawn as salary and interest, and since only the salary and interest received by Adams during the calendar year is included, there is almost no difference in total income taxed in each form. The corporate income for the year ended March 31, 1960, was only $1,578.18, so assuming ratable earnings each month, only $394.55 of extra earnings is included in the corporate forms.

There are limitations which pertain to the use of such devices. A firm must be sure that all such transactions are bona fide and that they are no more liberal than if non-stockholders were involved. Adams has kept this in mind, so this case provides an example of effective tax planning. Adams has used discretion and common sense, yet has kept the tax within about $50 of what it would have been in the partnership form. Note that the firm even paid small dividends in three years. It is not likely that the Internal Revenue Service would challenge this plan.

Conventional Corporation with No Tax Planning

The last column in Table 3 is labeled "no planning." This does not mean that the procedures which result in the most tax were sought out in making the computations for this column. Rather, the following assumptions were made: that Adams was paid an annual salary of $6,000 and that the building was contributed to the corporation instead of being retained by Adams and rented to the corporation. The difference between the salary and rent actually drawn, less the building expenses paid by Adams, is treated as dividends.

Summary

This case has reviewed a typical small corporate business which has followed good tax planning. Even with this good tax planning, taxes were higher than they would have been if the firm had been operated as a proprietorship or as a partnership of Adams and his wife. The firm was incorporated to attain business advantages; the owners feel the extra tax is a small price to pay for corporate advantages.

The partnership-like tax option election under Subchapter S was not available during most of the period covered by this study. Had it been available, and had the firm elected this method, the tax could have been the same as in the partnership form, yet the business advantages of the corporate form could have been preserved.

If a typical method of operations (wherein the previous business and its assets were transferred to the corporation, a fairly high salary is drawn each month, and additional withdrawals are in the form of dividends) had been followed, total tax would have been considerably higher than under the optimum tax planning which the firm employed. It is obvious, therefore, that careful tax planning is essential in the conventional corporate form if a small-business is not to pay far more

than its fair tax. The tax planning employed by Adams included three features: (1) a bonus based on profits was paid to Adams each year, (2) the building was retained by Adams and was rented to the corporation for a percentage of gross receipts, and (3) interest was paid on loans from Adams.

In changing to the corporate form, Adams followed procedures necessary to the non-taxable transfer of his proprietorship to the corporation in exchange for the capital stock of the corporation. Although this is a simple procedure, all of the statutory requirements must be precisely compiled with, or the transfer is taxable. Underlying all of the statutory provisions is the basic requirement that the intent must be to continue to operate a business in the corporate form. It is advisable in all tax planning to obtain the advice of an expert.

SUGGESTED INCUBATOR ASSIGNMENT

1. What kind of tax payment schedule do you have for your business for the various Federal, State, and local taxes?

2. How do you plan for and set aside funds to meet these tax payments in time?

3. What method do you use in your financial records to identify and compute business income, expense, and tax obligations.

   For land and buildings?
   For equipment?

5. Could a new decision on lease versus ownership save you tax dollars? Explain.

6. What kind of professional assistance on your tax problems can the following people give you?

   Government tax authorities?
   Professional management consultants?
   Accountants?
   Attorneys?

   Have you used any of these services?

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U.S. GOVERNMENT PRINTING OFFICE : 1966 O - 226-780

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