

Duvall & Associates, Inc.

Taking Care of Business

TAX CLASSIFICATION OF PAYMENTS

"Shopping for labels...it's all I'm thinking of." Fergie

When cash (or modern cash equivalents) changes hands, the parties generally have some leverage regarding the tax characterization - and even timing - of the transaction.

But one constant must be acknowledged, both parties must be mutually consistent in the tax treatment. If the transaction is deductible by the payor - it must be taxable to the payee. And both parties must be consistent if the deal is considered an immediately non-taxable event.

Businesses can basically classify payments as: (1) deductions, (2) assets purchase, (3) loans or (4) dividends (if payments to owners). In turn, the recipient would have to conform by treating monies received as: (1) income, (2) sale of assets, (3) loans, or (4) dividend income.

On the personal level, individual payors may report payments as: (1) deductions, (2) asset purchases, (3) loans or (4) gifts.

Loans are the wild-card in the tax deck. If both parties initially treat the transaction as a loan - no immediate taxable event has occurred. Thus, eventual classification and timing of the event is controllable and delayed until a better day.

Example A - Company X has bank loans with covenants which limit distributions to owners (utilizing a percentage of annual profits formula). However, the covenants are silent regarding loans to Owner. During the year, Company X treats payments to Owner as loans - to be re-classified as distributions to formula maximums at year end. Payments in excess of covenant maximums remain as balance sheet loans - the nature of which can be determined later the ensuing year.

Be aware of your options regarding classification of payments and clearly document in writing your agreement with the other party (to the transaction) as to conforming tax treatment thereof. The IRS tends to respect such agreements since what helps one party often hurts the other in like fashion - so the IRS breaks even on the deal.

Alan Duvall is a certified public accountant in Dayton. Contact him at Alan@Duvallcpa.com.